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In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 41.

GUY T. HELVERING,
COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

THE STRONG MANUFACTURING COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO
THE UNITED STATES CIRCUIT COURT OF APPEALS
FOR THE SIXTH CIRCUIT.

BRIEF OF THE STRONG MANUFACTURING COMPANY, RESPONDENT.

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ERRATA.

The Circuit Court opinion in the instant case is erroneously set forth on pages 1 and 69 herein as being reported at 124 F. (2d) 397. The correct citation is 124 F. (2d) 360.

The related *Ohio Leather* and *Warren Tool* cases are reported at 124 F. (2d) 397.

The Findings of Fact and Opinions of the U. S. Board of Tax Appeals (41 B. T. A. 1273), referred to on page 1 herein as "Appendix A," should have been referred to as "Appendix B."

In the Supreme Court of the United States

OCTOBER TERM, 1942

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THE STRONG MANUFACTURING COMPANY,
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ON WRIT OF CERTIORARI TO
THE UNITED STATES CIRCUIT COURT OF APPEALS
FOR THE SIXTH CIRCUIT.

BRIEF OF THE STRONG MANUFACTURING COMPANY, RESPONDENT.

I. NATURE OF THE CONTROVERSY.

This cause comes before this Court at the instance of the Commissioner of Internal Revenue, after his petition for a writ of certiorari from the decision of the United States Circuit Court of Appeals for the Sixth Circuit was allowed. The opinion of the United States Circuit Court of Appeals is printed in "Appendix A" of Respondent's Brief and is reported in 124 F. (2d) 397. The Findings of Fact and Majority and Minority Opinions of the United States Board of Tax Appeals (41 B. T. A. 1273) are attached to Respondent's Brief as "Appendix A."

The Circuit Court of Appeals and Board of Tax Appeals held that The Strong Manufacturing Company was entitled to a credit under Section 26 (c)(2) of the Revenue Act of 1936 by reason of the payment of $46,500.00 of its profits pursuant to a note and mortgage, executed prior to May 1, 1936. It was further held that said contract required the "application" of said amount of the earnings "as of" the taxable year 1936, or its irrevocable setting aside as contemplated by the statute. The Commissioner of Internal Revenue here disputes the correctness of the decisions of the Circuit Court of Appeals and of the Board of Tax Appeals.

The Strong Manufacturing Company will hereinafter be referred to as "the Taxpayer." The Commissioner of Internal Revenue will hereinafter be referred to as "the Commissioner." Italics used in the brief are ours, unless otherwise noted.

At the request of the Solicitor General Taxpayer stipulated that certain portions of the record before this Court should not be printed, without prejudice, however, to the right of either party to refer, in oral and written argument, to any portion of such record whether or not printed. All Taxpayer's references to unprinted portions of the record will be designated "OR." All Taxpayer's references to parts of the printed record lodged in this Court will be identified as "PR."

Jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

II. QUESTION PRESENTED.

Is the Taxpayer entitled to a credit on its 1936 surtax on undistributed profits under Section 26 (c)(2) of the 1936 Revenue Act, based on the payment of $46,500.00 of Taxpayer's 1936 profits on a note and mortgage executed

by it April 15, 1932, which required Taxpayer to apply forty per cent. (40%) of the 1936 profits of Taxpayer in retirement of said obligation?*

III. STATUTES AND REGULATIONS INVOLVED.

(1) Statutes.

Taxpayer's claim to a credit in this case, which was unanimously affirmed by the United States Circuit Court of Appeals and the Board of Tax Appeals, is governed by the following statutes:

Section 14 of the Revenue Act of 1936:

"Sec. 14. *Surtax on Undistributed Profits.*

(a) Definitions.—As used in this title—

• • •

(2) The term 'undistributed net income' means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

• • •

(June 22, 1936, 9:00 P. M., c. 690, Title I, Section 14, 49 Stat. 1665; Aug. 26, 1937, 10:00 A. M., c. 815, Title IA, Section 2, 50 Stat. . . . .)" 6 F. C. A. (1937) 21.

Section 26 of the 1936 Revenue Act, under which Taxpayer claims a credit:

"Section 26. CREDITS OF CORPORATIONS.—In case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

• • •

---

*By reason of the stipulation between the Taxpayer and Commissioner, settling the matter of allowable deductions for repair and replacement expense claimed by Taxpayer in its 1936 income tax return and the decision of the Board of Tax Appeals confirming said compromise, that issue is removed from the case. OR. 23, 32-33.

(c) CONTRACTS RESTRICTING PAYMENT OF DIVIDENDS.

• • •

(2) DISPOSITION OF PROFITS OF TAXABLE YEAR. An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word 'debt' does not include a debt incurred after April 30, 1936.

• • •

(June 22, 1936, 9:00 P. M., c. 690, Title 1, Section 26, 49 Stat. 1664.)" 6 F. C. A. (1937) 50-51.

(2) Regulations of Bureau of Internal Revenue under Revenue Act of 1936.

Regulations of the Bureau of Internal Revenue under the Revenue Act of 1936, pertinent to the question here presented, are:

"ART. 26-2. CREDIT IN CONNECTION WITH CONTRACTS RESTRICTING PAYMENT OF DIVIDENDS.—(a) The credit provided in section 26(c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. • • • The provisions recognized by the Act are of two general types, as follows:

• • •

(2) Those which come within section 26(c)(2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

* * *

(c) Disposition of profits of taxable year.—Under the provisions of Section 26(c)(2), a corporation is allowed a credit in an amount equal to that portion of the earnings and profits of the taxable year which, by the terms of a written contract executed by the corporation prior to May 1, 1936, and expressly dealing with the disposition of the earnings and profits of the taxable year, it is required within the taxable year to pay in, or irrevocably to set aside for, the discharge of a debt incurred on or before April 30, 1936. The credit is limited to that amount which is actually so paid or irrevocably set aside during the taxable year pursuant to the requirements of such a contract.

Only a contractual provision which expressly deals with the disposition of the earnings and profits of the taxable year shall be recognized as a basis for the credit provided in section 26 (c)(2) * * *. A contractual provision, however, shall not be considered as not expressly dealing with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of 'net income,' 'net earnings,' or 'net profits.'"

(Regulations 94 of Bureau of Internal Revenue under Revenue Act of 1936, 120-121, 123.)

IV. STATEMENT OF FACTS.

The Taxpayer is an Ohio corporation in the Village of Sebring, Mahoning County, Ohio, organized in 1932 for the purpose of manufacturing enamelware. OR. 36-37, Ex. 1, OR. 67. Taxpayer purchased its entire plant and equipment from the Central United National Bank, Cleveland, Ohio, Trustee for the bondholders of the Sebring Manufacturing Company, about April 15, 1932, for the sum of $50,-

000.00. OR. 35-37. The entire purchase price was evidenced by a note secured by a mortgage executed to the Central United National Bank (hereinafter referred to as "the Bank"). OR. 37-38. The note reads as follows:

"For value received The Strong Manufacturing Company, a corporation of the State of Ohio, promises to pay to Central United National Bank, Cleveland, Trustee, or order, Fifty Thousand Dollars ($50,000) in the following installments (all payments to be made at the principal office of said Central United National Bank in the City of Cleveland, Ohio):

$2,000 on April 15, 1934
3,000 on April 15, 1935
5,000 on April 15, 1936
6,000 on April 15, 1937
7,000 on April 15, 1938
8,000 on April 15, 1939
9,000 on April 15, 1940
10,000 on April 15, 1941

Any unpaid portion of the said principal sum shall bear interest from April 15, 1932, at the rate of six per centum (6%) per annum until paid; such interest shall be paid semi-annually at said office of Central United National Bank on the 15th day of October and April in each year.

This note is issued pursuant to, and payment of the principal thereof and of the interest thereon is secured by a certain first mortgage deed dated as of April 15, 1932, duly made, executed and delivered by The Strong Manufacturing Company to Central United National Bank of Cleveland, Trustee, to which mortgage deed reference is hereby made to the same effect as if herein set forth for a statement of the properties and rights mortgaged and pledged and the nature and extent of the rights of the holder hereof.

As provided in said mortgage deed installments of the principal sum hereof may be anticipated in whole or in part by The Strong Manufacturing Company. In addition The Strong Manufacturing Company shall apply forty per cent. (40%) of its net earnings in and for any calendar year beginning January

1, 1934 upon the unpaid balance of said purchase price, provided that the amount so applied shall never be less than the installment of the purchase price specified for payment in such year, all as more fully set forth in said mortgage deed. All payments in excess of the installment required under the terms hereof in any year, whether voluntary or obligatory, shall be applied by the holder hereof against the latest maturing installments of the principal sum hereof."—Ex. 2, PR. 26-27.

The chief provisions of the underlying mortgage (Ex. 3, PR. 28-40) pertaining to this controversy are as follows:

"ARTICLE I.

Anticipation of Payments upon Note.

(1) The Company covenants and agrees that until the principal and interest of the note hereby secured shall have been fully paid and beginning on January 1st, One Thousand nine hundred thirty-four, the Company will apply forty per centum (40%) per annum of its net earnings for any calendar year in payment of the interest accruing and becoming payable upon such note in such year, and the balance of the principal amount of such note unpaid prior to April 15th in such year; provided, however, that the covenant herein made shall not be construed to relieve the Company from the payment on April 15th in such year of the installment specified for payment by the terms of said note nor of the regular interest payments in such year, likewise as specified in said note. The term 'net earnings' as herein used means the gross earnings from the business of the Company for such calendar year, less all current expenses of the business, all taxes payable in such year by the Company and fixed charges other than those created by the note hereby secured.

Settlement for all amounts becoming payable under this provision in excess of the principal and interest payments absolutely required in the calendar year as of which such net earnings are determined shall be made by the Company to the Bank not later than April 15th of the succeeding year.

(2) The Company covenants and agrees that so long as the principal and interest hereby secured remain unpaid, it will furnish to the Bank quarterly statements of the financial condition and operations of the Company, and in addition, shall on or before April 15th in each year furnish to the Bank a detailed balance sheet as of the close of the preceding calendar year, audited by public accountants acceptable to the Bank. The Company shall also furnish to the Bank, at any time that it may so demand in writing, such information as may, in the Bank's judgment, be necessary and proper to give it sufficient ground for the taking or not taking of any action required or permitted hereunder, and shall permit the Bank or its agents, upon like demand at any time, to examine its premises, property, records and books of account, and the Company shall and will do everything in its power to facilitate such examination.

(3) The Company may, at its option, at any time so long as it is not in default under any of the provisions hereof, anticipate any part of the principal amount secured hereby. Any sums paid by the Company in excess of the principal and interest payments fixed by the terms of the note hereby secured, whether made voluntarily under the provisions of this paragraph or under the provisions of paragraph (1) of this Article I, shall be applied by the Bank in payment of the latest maturing installments specified in said note;

* * * * *

ARTICLE IV.

Remedies on Default.

(1) If the Company shall make default in the payment of any interest or principal specified in the note hereby secured, and any such default shall have continued for thirty (30) days; or shall default in the performance of its covenants contained in Article I, Paragraph 1, hereof, and such default shall have continued for thirty (30) days; * * * the Bank may declare the entire principal then unpaid immediately due and payable, and the same and the interest accrued

thereon shall thereupon become and be immediately due and payable, anything in said bonds or herein contained to the contrary notwithstanding. * * *

(2) No waiver by the Bank of any such default by the Company whether such waiver be full or partial, shall extend to or be taken to affect any subsequent default or to impair the rights resulting therefrom."

The provisions of the note respecting the application of forty per cent. (40%) of Taxpayer's net earnings of each year on the note and the like provisions found in Article I, Paragraph (1) of the mortgage (PR. 31-32) were inserted by the Bank to insure that in prosperous years Taxpayer would devote a substantial portion of its profits to the retirement of the note and mortgage and, to that extent, anticipate and protect the Bank against inability of the Taxpayer to pay the obligation in lean years. OR. 38.

In 1934 Taxpayer was handicapped by lack of working capital and obtained from the Bank a written extension on a then due installment of $2,000.00 principal and $3,500.00 interest on said note and mortgage. OR. 40, Ex. 4, OR. 102. The extension agreement was specifically conditioned that "such extension shall not be construed as a waiver of any subsequent defaults." Ex. 4, OR. 102-103. See also Ex. 3, Art. IV, Par. 2, PR. 36. However, the Bank never waived or made any concession whatsoever in respect to the covenants of the note and mortgage requiring Tavpayer to apply forty per cent. (40%) of its net earnings in payment thereof. OR. 48, 51-52.

Taxpayer's estimated profits on September 30, 1936, were $86,000.00, and at that time it had unfilled orders on its books approximating the amount of $100,000.00. OR. 44, 46. Taxpayer's net income for the year 1936, as reported in its income and excess profits tax return for that year, was $126,786.04. Ex. 1, OR. 67. On January 1, 1936, the balance due from the Taxpayer on said note and mort-

gage was $47,000.00. OR. 39. Said amount was less than forty per cent. (40%) of its profits for the year 1936. During 1936 the Taxpayer made payments out of profits on the principal of its note and mortgage, exclusive of interest,* on the dates and in the amounts as follows:

2/15/36	$2,500	7/31/36	$ 1,000
4/15/36	2,500	8/14/36	500
5/15/36	500	8/31/36	2,000
5/29/36	1,000	9/15/36	500
6/15/36	500	10/15/36	34,000
6/29/36	1,000		
7/14/36	500	Total	$46,500

OR. 39, 44-45, 47; PR. 54. Ex. 5, OR. 107-129.

The Bank waived payment of principal in the sum of $500.00 and interest of $117.50 and accepted $46,500.00 in full of the balance due on the note and mortgage. OR. 39, 46-47, 48.

Because of the fact that the Taxpayer is a fabricator of raw materials and the computation of its profits is based, in part, on a physical inventory of its raw materials, materials in process, and finished goods, it was an impossibility for it to accurately determine its profits for the year 1936 on December 31, 1936. PR. 24. Taxpayer filed its 1936 income tax return on the accrual basis. Ex. 1, OR. 71. Taxpayer's admitted income and excess profits tax liability for the year 1936 is $29,136.99, constituted as follows:

Total normal income tax returned for 1936 (Ex. 1, OR. 65)	$17,616.83
Additional normal tax liability, arising from compromise of disputed deductions for repair and replacement expense, confirmed by the decision of the Board of Tax Appeals, returned for 1936 (PR. 16-17; OR. 32-33)	$ 2,133.63

* Payments of interest made by the Taxpayer on the note and mortgage in 1936 are not material to the controversy and reference to them is omitted. OR. 39.

Surtax on undistributed profits returned for 1936 (Ex. 1, R. 65)	$ 7,358.97
Excess profits tax return by Taxpayer for 1936 (Ex. 1, R. 65)	$ 1,607.16
Additional excess profits tax, through compromise of disputed items of repair and replacement expense, confirmed by the Board of Tax Appeals in its decision (PR. 16-17; OR. 32-33)	$ 420.40
TOTAL	$29,136.99

The deficiency surtax assessed by the Commissioner upon the alleged undistributed profits of Taxpayer for 1936, but disallowed by the Board of Tax Appeals in this case, is $14,776.89, less the proper reduction of that amount to reflect the adjustments agreed upon by the parties at the hearing before the Board of Tax Appeals.

V. FACTS DISTINGUISHING STRONG CASE FROM OHIO AND WARREN CASES.

The facts in the Strong case and the companion Ohio and Warren cases (Oct. Term 1942, Nos. 40 and 42) are substantially distinguishable only, in that under the Strong note and mortgage payment due could only be made in cash. In the Ohio and Warren cases the taxpayers had the option of paying in cash or depositing debentures or bonds issued under the respective indentures. Neither the Board of Tax Appeals nor Circuit Court of Appeals considered this difference of fact material. The Commissioner has not and does not now seek to differentiate his contentions based on any such distinction in facts. Hence the point will be passed without further discussion.

VI. SUMMARY OF ARGUMENT.

It is the view of the Commissioner that Taxpayer's note and mortgage fail to comply with Section 26 (c)(2) of the 1936 Revenue Act because it did not require forty per cent. (40%) of Taxpayer's 1936 profits paid thereon within that taxable year *in terms, expressly* [redacted] to be irrevocably set aside for that purpose. The decisions of the United States Circuit Court of Appeals and of the Board of Tax Appeals unanimously held that the Taxpayer's contract required the irrevocable setting aside of 40% of the Taxpayer's profits "as of" the taxable year 1936, and fully complied with the requirements of that section. PR. 14-15, 48. Commissioner admits that under his interpretation, Section 26 (c)(2), in fact, affords no relief. Commissioner's Brief, 20, footnote. The Taxpayer's interpretation of Section 26 (c)(2) follows the clear intent of Congress and the language of the statute.

VII. ARGUMENT.

A. Argument on Facts.

1. A CONTRACT CONFORMING TO THE COMMISSIONER'S INTERPRETATION OF SECTION 26 (c)(2) WOULD BE IMPOSSIBLE OF PERFORMANCE BY TAXPAYER AND ALL CORPORATIONS REQUIRED TO TAKE A PHYSICAL INVENTORY TO DETERMINE ANNUAL PROFITS.

The Taxpayer here involved is a typical corporation engaged in the manufacturing of raw material into finished products. We are persuaded that it becomes necessary, in any extended study of the application of Section 26 (c)(2) of the 1936 Revenue Act to corporations, to make due allowance for the wide differences in the practical situation where a corporation such as a bank* is involved and where

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* It is noteworthy that banks and trust companies who could perform a contract conforming to Section 26 (c)(2) of the 1936 Internal Revenue Act, as interpreted by the Commissioner, were wholly exempt from the 1936 surtax on undistributed profits. c. 690, Title I, Section 104, 49 Stat. 1677; 6 F. C. A. 77, Section 107 (Section 104) (b).

a corporation fabricating finished products from raw materials is involved. A bank deals in cash or in evidences of indebtedness whose realizable value is quite readily ascertainable. A bank does not produce, but returns its earnings by making loans or by the value of the use of its money. In a bank the value of money, of course, fluctuates, but ordinarily in a readily ascertainable degree. Money, or assets readily converted into money, are its chief assets. The future value of the assets of a bank also can be determined with a fair degree of accuracy by persons familiar with the surrounding conditions. The inventory of the assets of a bank, and economic forces affecting those assets, are subject to standards permanent enough and easily enough ascertainable to be dealt with quickly.

The case of the assets of a manufacturing corporation are entirely different. The assets are large in number, with varying lives, in varying degrees of fabrication, and with varying values. As an example, Taxpayer manufactures over two hundred different enamelware products with many variations of those products, with degrees of such manufacture constantly varying from the raw material to the finished product, and with values from a few cents to hundreds of dollars. They present a problem of a multiplicity of more or less minute units constantly shifting and ever-changing. Obviously the practical determination of profits in the latter case differs greatly from the determination in the former case. We are here dealing with a corporation manufacturing raw materials, namely, enamelware, in many different forms and we deem it material that this fact be kept constantly in mind.

The Commissioner would have this Court believe that Congress intended, in enacting Section 26 (c)(2), that a contract, to comply with its requirements, would demand the ascertainment of the profits of the subject corporation on December 31, 1936, and the payment of the required percentage of its profits on the indebtedness evidenced by that contract. Such a condition would be impossible of perform-

ance by the Taxpayer and by the majority of corporations to which Section 26 (c)(2) was meant to apply. As we have shown, only a bank or a corporation dealing in a like commodity whose value was constant and easily ascertainable from day to day could conform itself to the rigorous and impracticable demands of Section 26 (c)(2) as interpreted by the Commissioner. This is borne out by the evidence in this case.

Taxpayer's auditors, Messrs. Clark and Collins, a firm of Certified Public Accountants, who prepared the Federal Income Tax Return in this case and participated in the representation of the Taxpayer in this controversy before the Collector of Internal Revenue and before the Board of Tax Appeals, has offices in the cities of Cleveland, Youngstown, Canton, and Warren, Ohio, and has some two hundred active clients, representing a cross-section of the industrial corporations in northeastern Ohio. PR. 22-25. A member of that firm, Sidney J. Collins, also a Certified Public Accountant, engaged in accountancy since 1921 and presently a member of the Ohio State Board of Accountants, testified that neither the Taxpayer nor any industrial corporation could determine its profits for the past year on December 31st. PR. 22-26. Mr. Collins' testimony is as follows (PR. 24):

> "Q. Would it have been possible to determine the exact earnings of the Strong Manufacturing Company as of December 31, 1936, for the preceding taxable year on January 1st? I mean, would it have been physically possible?
>
> A. No. The whole structure of accounting is based (on the condition of the company) at the close of the year, December 31st, at midnight. The books must yet be closed, inventories must be checked. Proper recognition of that is given by the income tax requirement that tax return be filed two and a half months following the close of the year. So it is actually impossible to determine the exact profits in the calendar year as of December 31st in that year.

Q. And this applies to the Strong Manufacturing Company?

A. Yes. And in the study of the law under 26C-2 we had to—

Mr. Pierson: Now, if Your Honor please—

A. We had—I am going to state what we told the company.

Mr. Pierson: All right.

A. We instructed or notified this company that the construction of that law was our opinion,—rather, our opinion was that the construction of 26C-2 was that they must pay or irrevocably set aside forty per cent of the profits in the year, 1936. We did explain to them, upon their request, as to this payment, it would be physically impossible for them to be sure of profits until after the books were closed. We, therefore, put our own construction on this contract that the law, including irrevocably setting aside, was taking care of that contingency where the company was not sure as of December 31st that the profits would be sufficient to require the payment of forty per cent." (Parenthetical matters ours.)

The Witness, Collins, further testified on page 25 (PR):

"By Mr. Powers:

Q. First, Mr. Collins, I will ask you how long have you been in the accounting business?

A. Since I came back from France, 1919.

Q. Over that period of time, what has been your experience?

A. I have served as an instructor in accountancy in the university, been actually engaged in accounting since 1921 in public practice. During that time I have appeared before the Board of Tax Appeals on income tax many times.

Q. How many companies have you prepared income tax returns for?

A. It would be rather difficult, Mr. Powers, but we have some two hundred active clients at the present time.

Q. Are they conducting one type of business, or are they diversified?

A. All kinds.

Q. Would you consider they represent a cross section of industrial activity in this vicinity?

A. I do.

Q. I will ask you, Mr. Collins, if any of those corporations could accurately determine their profits on December 31st of the year in which those profits are earned?

A. It would be physically impossible to determine the actual profits of the calendar year as of the last day.

Q. Of any of the corporations you represent?

A. Any corporations, with one exception of the bank, which, as of the close of the next day, there is a trial balance which does show the profits as of that year.

Q. How about industrial corporations?

A. Industrial corporations, no. I might add, any corporation that has a physical inventory on which it bases its profits, could not take that inventory until the close of the year. If they did, they would be subject to penalty from the income tax department for not having the correct inventories.

Q. And therefore, if a contract or a mortgage obligation provided for the application of a certain percentage of profits payable in the year in which the profits were earned, it would be impossible for a corporation to comply with those conditions?

Mr. Pierson: I object to that, Your Honor.

A. Absolutely.

Mr. Pierson: Just a moment. I object to that, Your Honor.

The Member: I will take it for what it is worth. Overrule the objection.

Mr. Pierson: No questions."

We will hereafter show that Congress had manufacturing concerns such as Taxpayer specifically in mind and must have selected the terms used in Section 26 (c)(2) with

care to cover such contracts as the Taxpayer's. It is hardly necessary here to indulge in further demonstration that the Commissioner's view is not in accord with the practical exigencies of an accurate determination of Taxpayer's profits. On the contrary, the interpretation of Section 26 (c)(2), adopted by the United States Circuit Court of Appeals and the Board of Tax Appeals in their decisions, is not only practical but does no violence to the statutory language.

2. THE NOTE AND MORTGAGE BEFORE THE COURT IN TERMS REQUIRED THE PAYMENT OF ALL AMOUNTS CONSTITUTING THE BALANCE DUE ON JANUARY 1, 1936, OUT OF TAXPAYER'S PROFITS IN THAT YEAR.

The Commissioner takes the further view,—which the Circuit Court overruled in its opinion (PR. 48-49)—that the note and mortgage in issue required a minimum payment of $5,000.00, in any event, and that Taxpayer was not required to make that payment out of its 1936 profits, even though 40% of Taxpayer's 1936 profits were sufficient to cover that as well as all other payments due in 1936. Commissioner's Brief 6, 15-16. On the contrary, Taxpayer contends that the literal terms of the note and mortgage in issue permitted the payment of the minimum installment of $5,000.00 due in 1936, in any event, or permitted such part of it to be paid out of other funds of the Taxpayer, only if and only to the extent that 40% of Taxpayer's 1936 profits would not satisfy it. First, however, Taxpayer wishes to show that the provisions of Taxpayer's note and mortgage pledging a substantial portion of its earnings were not casually inserted as a make-weight.

The bondholders, whom the Bank, as mortgagee, represented, had seen the predecessors of the Taxpayer go through the prosperous times of 1925 to 1929 without paying their bonds. Instead, when the crash came, the bondholders' debtor went into bankruptcy and the bondholders

were forced to become the owners of an idle enamelware plant. Profiting by their past experience, the bondholders insisted, in dealing with Taxpayer, on participating in its profits,—in addition to all other security provided by the note and mortgage for the payment of the indebtedness. Anthony Poss, Corporate Trust Officer of the Bank, OR. 36, 38-39. The undisputed testimony of Mr. Poss,—far from giving any support to the Commissioner's contention that the terms of the note requiring payment in specified installments were the most important,—shows that the terms of the note and mortgage requiring the application of profits on the indebtedness were paramount in the mind of the Bank. Mr. Poss testified on direct examination, as follows (OR. 38):

"By Mr. Powers:

Q. Are you familiar with the provisions in the note and mortgage concerning the application on these obligations of the profits, earnings of the Strong Manufacturing Company?

A. I am.

Q. Will you state to the Court, if you know, how this provision happened to be put in these instruments, and who required it?

A. It was required on the part of the Central National Bank, as trustee, and they were certified because of the fact that the Strong Manufacturing Company was given, independent of the property, a mortgage representing the entire purchase price, and the representative of the bank, as trustee, felt in that event, should the company be prosperous for a few years, a portion of their profits should be devoted to the payment of this mortgage, so that we would not come to the point, five or six years hence, where the mortgage might be half paid off and the company become involved in difficulties and perhaps have the profits go out in dividends, and the Bank, as trustee, have the property back in its hands."

As further evidence of how seriously the Bank followed the performance of Taxpayer in this regard, it will be noted

that *quarterly* statements of earnings of Taxpayer were required in said mortgage to be furnished to the Bank—and they were, in fact, furnished. Ex. 3, Art. I(2), PR. 32; OR. 39.

The note in issue (Ex. 2) does call for a minimum installment of $5,000.00 on April 15, 1936, but *further* requires that such payment shall be made only out of 40% of Taxpayer's 1936 profits, if they are, and to the extent, so much of such profits are sufficient. Reference is made to said note (Ex. 2), para. 4, reading:

> "As provided in said mortgage deed installments of the principal sum hereof may be anticipated in whole or in part by The Strong Manufacturing Company. In addition The Strong Manufacturing Company shall apply forty per cent. (40%) of its net earnings in and for any calendar year beginning January 1, 1934, upon the unpaid balance of said purchase price, *provided that the amount so applied shall never be less than the installment of the purchase price specified for payment in such year,* all as more fully set forth in said mortgage deed." Ex. 2, OR. 86.

The word "amount" in the italicized language clearly refers to the 40% of the Taxpayer's profits and the whole clause should be interpreted to read—provided that the amount "of Taxpayer's net earnings" so applied on the note shall never be less than the minimum installment stated in dollars. This clause emphasizes that the Bank considered the provisions of the note as to the application of the stipulated percentage of profits of equal or more importance than the provisions requiring minimum annual dollar payments. The Bank, no doubt, also inserted this clause to take care of a situation where, say, 40% of Taxpayer's annual profits amounted to $3,000.00 and the minimum dollars payment in that year called for $5,000.00. In that event, Taxpayer would be required to pay $5,000.00 from its profits for that year—regardless of what percentage that amount was of the total annual profits. But it

is clear that only if the annual profits of Taxpayer were insufficient to satisfy the stipulated minimum installment that Taxpayer could pay all or a part thereof out of funds other than its profits for that year.

The note represents the principal obligation of the Taxpayer and its terms are controlling. However, like reference can be made to the mortgage securing the note for confirmance of the contentions of the Taxpayer. Article I, Section 1 of the mortgage, Ex. 3, PR. 31-32, reads as follows:

> "The Company covenants and agrees that until the principal and interest of the note hereby secured shall have been fully paid and beginning on January 1st, One Thousand nine hundred and thirty-four, the Company will apply forty percentum (40%) per annum of its net earnings for any calendar year in payment of the interest accruing and becoming payable upon such note in such year, and the balance of the principal amount of such note unpaid prior to April 15th in such year; provided, however, that the covenant herein made shall not be construed to relieve the Company from the payment on April 15th in such year of the installment specified for payment *by the terms of said note* nor of the regular interest payments in such year, likewise as specified in said note. * * *"

The reference here made to the payments required "by the terms of said note" incorporates in the mortgage by reference not only the terms thereof in respect to specific dollar payments but also the terms defining the source out of Taxpayer's funds from which such payments were obligated to be made.

The obligation to make all 1936 payments on the note and mortgage out of its profits for that year was so interpreted by the Taxpayer's Auditors, its counsel, and the Taxpayer's officials, and the uncontradicted evidence in this case shows that all payments thereon in 1936 were, in fact, made out of the profits of the Taxpayer. OR. 44-45, 51, PR. 24-25.

The Taxpayer, therefore, submits that the decision of the court below was utterly correct in holding that Taxpayer's note and mortgage required it to irrevocably set aside $46,500.00 of its 1936 profits within the terms of Section 26 (c)(2) for the payment of said indebtedness,—of which amount $5,000.00 was paid on or before April 15, 1936, and the balance of $41,500.00 was paid on or before Oct. 15, 1936.

B. Argument on the Law.

1. CONGRESS CLEARLY INTENDED THAT SECTION 26 (c)(2) OF THE 1936 REVENUE ACT SHOULD GRANT A DEDUCTION AS TO PROFITS APPLIED UNDER CONTRACTS CONTAINING PROVISIONS IDENTICAL WITH THAT IN ISSUE IN THIS CASE.

The Commissioner further seeks to establish, in substance, that the legislative history of Section 26 (c)(2) shows that only contracts in terms requiring payment or irrevocable setting aside of profits would entitle the affected taxpayers to credits. Obviously, there is no language to that effect in the statute. Moreover, the legislative history of the section—that cited by the Commissioner and that hereafter referred to by Taxpayer—wholly supports the decisions of the tribunals below.

The surtax on undistributed profits was originally inspired by the message from the President to Congress, dated March 3, 1936. The President's message read, in part, as follows (Hearings before the Ways and Means Committee, pages 2-3):

> "I invite your attention, however, to a form of tax which would accomplish an important tax reform, remove two major inequalities in our tax system, and stop 'leaks' in present surtaxes.
>
> • • •
>
> "The accumulation of surplus in corporations controlled by taxpayers with large incomes is encouraged

by the present freedom of undistributed corporate income from surtaxes. * * *"

It will be conceded that the purpose of the act, as stated in the President's message, was fully intended by Congress to be carried out, in the 1936 Revenue Act. As stated in *Paul and Mertens Law of Federal Income Taxation*, 1939 Cumulative Supplement, page 1390, Section 32A.01:

> "An additional factor entering into the legislative purpose in the enactment of the undistributed profits surtax was the belief that the tax would be of economic benefit in increasing the velocity of the monetary circulation and maintaining purchasing power by the distribution of money to stockholders.
>
> The general basic purpose of the undistributed profits surtax may be said to provide a system of taxation which, so far as possible, would 'in effect treat the corporation as a "conduit to income."' "

And another authority has said:

> "Even if the denomination by Congress of the tax as a 'Surtax on Undistributed Profits' be disregarded, the purpose of Congress was, clearly, to force the distribution of profits, and for all practical purposes the tax is imposed on the *undistributed* portion of the profits." *Homer Hendricks "The Surtax On Undistributed Profits of Corporations."* 46 *Yale Law Journal*, 19, at page 48.

It follows conversely that it was not the thought of proponents of the tax, or of Congress,—within the limits of Section 26 (c) of the 1936 Revenue Act, *liberally construed*, —to impose the surtax on profits which were distributed or set aside, for payment on corporate indebtedness. This collateral, but equally controlling, purpose to grant relief in such instances is disclosed in the Report of the Sub-Committee of March 26, 1936, to the House Ways and Means Committee, recommending that corporate profits

obligated to discharge indebtedness be taxed at a flat rate.* Section XX of the Report of the House Sub-Committee reads, in part, as follows:

> "It is recommended that a corporation which has, prior to January 1, 1936, made a bona fide contract not to pay dividends, *or not to pay out as dividends a stipulated portion of its earnings and profits for the taxable year*, shall be taxed 22½% on the part of the adjusted net income which equals the earnings and profits which it is prohibited by the contract from using for the payment of dividends." Hearings before the House Ways and Means Committee, page 10.

Repeated references to this provision were made by members of the House Ways and Means Committee during the hearing and numerous protests were made by witnesses appearing before the Committee against any surtax whatever being imposed on such disposition of profits. House Ways and Means Committee Hearings, pages 63, 129, 177, 235, 278, 286, 315, 404, 406, 484, 567, 836. Special reference was made by many of the witnesses before the House Ways and Means Committee to mortgages containing clauses similar to that under consideration in this case. The Taxpayer particularly wishes to make reference to the statements of E. C. Alvord (House Ways and Means Committee Hearings, pages 803 to 841), formerly connected with the Treasury Department, who appeared on behalf of the United States Chamber of Commerce, and whose testimony and criticisms were evidently listened to with great interest. Mr. Alvord states (House Ways and Means Committee Hearings, pages 836-837) in his written statement filed with the Committee:

> "Corporations may be grouped into three classes, from a point of view of dividend-paying ability:
>
> * * *

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* Taxpayer has already paid a 1936 normal income tax and an excess profits tax on the amount in controversy. Ex. 1, OR. 65.

(2) Corporations prohibited by contract from declaring dividends, for example, by a clause in a *mortgage indenture* that a specified portion of the annual earnings and profits must be set aside to retire the indebtedness; • • •

Let us now examine the application of the proposal:

• • •

"(5) The corporation with a contract obligation will likewise be less favorably situated than a corporation privileged to pay dividends."

Mr. Alvord, in this statement, was protesting against Article XX of the Sub-Committee Report, quoted above, in respect to the tax of 22½% upon that portion of corporate profits required, by contract, to be set aside or paid on corporate debts. As a result of the protests before the Ways and Means Committee, the House Bill was even more liberal than the Bill as finally enacted in the matter of relieving undistributed profits from the surtax. The House Bill relieved all earnings where used to make up deficits from a surtax and applied a flat rate of 22½%. House Bill, Section 14. Section 15 provided similar relief as to profits which could not be paid out in dividends without violating a written contract in existence prior to March 3, 1936. Section 16 of the original House Act was equally liberal, in principle, in the case of certain debts in excess of the accumulated earnings and profits. See *Paul and Mertens Law of Federal Income Taxation*, 1939 Supplement, 1392, Note 28.

The effect of the House Bill, in the opinion of the Ways and Means Committee, was summarized as follows:

"This new plan of taxing corporate net income, in the opinion of your Committee, will not prevent the retention of earnings *sufficient to provide for legitimate corporate needs* but will discourage accumulation for which there is no sound reason." Ways and Means Committee Report No. 2475, 74th Cong., 2nd Sess., p.

8. *Paul and Mertens Law of Federal Income Taxation,* 1939 Supplement, 1392.

And as stated by Mr. Samuel B. Hill on the floor of the House (*Paul and Mertens Law of Federal Income Taxation,* 1939 Supplement, 1392, Note 28):

> "Now, that takes care of section 16 which we had not yet reached, but I am now going to call attention to section 15, which deals with contracts not to pay dividends. If a corporation as of March 3, 1936, finds itself in a position, by reason of a contract entered into with its creditors, not to pay dividends until it has paid its creditor his debt or has established a sinking fund, *or otherwise provided means of paying the obligation,* if it is under that handicap by reason of a written contract, then we allow the corporation a 22½ percent flat rate on that portion of the net income which it is unable to pay out, by reason of this contract, in dividends. Then you get a new base for the tax on the remainder under the general plan. Congressional Record—House, Vol. 80, No. 84, p. 6196, April 23, 1936."

And in the opinion of eminent tax authorities:

> "The House Bill provided for certain exceptional cases involving corporations which could not pay out dividends, or where 'sound policy' demanded the non-payment of dividends." *Paul and Mertens Law of Federal Income Taxation,* 1939 Supp. 1391-1392.

The House Bill, then, gave corporations relief from surtax where deficits existed, where certain types of indebtedness exceeded corporate surplus and accrued earnings and as to contracts preventing the payment of dividends. This is a compelling guide as to the liberal application Section 26 (c)(2) of the 1936 Revenue Act should be given, to Taxpayer's note and mortgage, for:

> "The spirit of this House Bill dominated the final Bill enacted (Section 26(c) of the 1936 Internal Revenue Act), but inasmuch as so many detailed changes were made *the original Bill is important as indicating*

the basic legislative intent underlying the new act." *Paul and Mertens Law of Federal Income Taxation*, 1939 Supplement, 1392. (Parenthetical matter ours.)

Important discussion of what was finally Section 26 (c) of the 1936 Revenue Act, and its application, was also had on the floors of the House and Senate, with the purpose of enlarging its scope. *Congressional Record—House*, Vol. 80, No. 86, p. 6451; *Congressional Record—Senate*, Vol. 80, No. 116, p. 9193.

Protests were renewed against the levying of any surtax in respect to corporate profits, required by contract to be devoted to the discharge of indebtedness, by witnesses before the Senate Committee on Finance, considering the 1936 Revenue Act. These protests received sympathetic response from the members of that Committee. Extended reference to the discussions that took place before the Senate Finance Committee would be redundant of what the Taxpayer has shown took place before the Ways and Means Committee. See Report of Hearings before the Senate Committee on Finance on H. R. 12395 (Revenue Act. 1936), pp. 107, 117, 316, 318, and 643. In general, the Bill was subject to more violent criticism in the Senate than when before the House. *Paul and Mertens Law of Federal Income Taxation*, 1939 Supplement, 1393-1396, Section 32A.03. This undoubtedly brought about the complete relief from all surtax of corporate earnings devoted to the discharge of indebtedness under the obligations of a written contract.

When the House Bill reached the Senate, Sections 15 and 16 were combined as subdivisions 26 (c)(1) and 26 (c)(2), respectively, of the Senate Bill. Section 26 of the Senate Bill was modified in conference but the language of 26 (c)(1) of the Senate Bill was retained intact and became subdivision 26 (c)(1) of the 1936 Revenue Act. *Paul and Mertens Law of Federal Income Taxation*, 1939 Supplement, 1392, Note 28.

As further indicating the liberal construction intended by Congress, as opposed to a technical application of the language used in the statute, it is to be noted that Section 26 (c)(2) contains the following liberalizing provision:

> "For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits." June 22, 1936, 9:00 P. M., c. 690, Title I, Section 26, 49 Stat. 1664, 6 F. C. A., 50, Title 26, Section 26 (c)(2).

The Commissioner, in that portion of his brief dealing with the legislative history of Section 26 (c)(2), undoubtedly demonstrates that Section 26 (c)(2) was intended to apply to contracts, only, which required that earnings must be paid or irrevocably set aside during the taxable year. The Commissioner falls into grievous error in drawing the conclusion that Section 26 (c)(2) should be interpreted to provide contracts must "expressly" or "in terms" set forth that earnings must be irrevocably set aside during the taxable year since the statute itself does not so state. Rather it is more logical to infer that the sponsors of the more liberal provision, qualifying contracts requiring payment in the "dividend" year accepted the compromise provision for payment or *irrevocable setting aside* of profits within the taxable year—not necessarily by express terms of a contract but also by implication. Surely, if the legislature intended a niggardly relief to the few fortunate corporations whose contracts, obligating profits to discharge indebtedness, contained the exact applicable language of Section 26 (c), this provision above-quoted would not have been inserted. Of course, the fact that Section 26 (c) applies only to contracts entered into *before* its enactment,—May 1, 1936,—leads to the conclusion that Congress intended that Section 26 (c) should apply to a class of contracts expressing the substance of the provisions Congress had in mind but with the innumer-

able variations of expression of which our language is capable. It is, therefore, fair to conclude that, if the undoubted purpose of Congress is to be observed, Section 26 (c)(1) and (2) of the 1936 Revenue Act must be construed to cover contracts,—including notes and mortgages, as the Taxpayer has shown Congress had in mind,—substantially, even if not with technical exactitude, within the requirements of said Section 26 (c). *Chess & Wymond, Inc. v. Glenn Collector* (Ky., 1941) 40 F. Supp. 666, 670.

The Court should give great weight to the legislative intent that Section 26 (c)(2) be liberally construed to bring the appropriate provisions of corporate contracts, including Taxpayer's note and mortgage and its performance thereof, within said Section.

In the case of *United States of America v. Katz*, (1926), 271 U. S. 354, 46 S. Ct. 513, 70 L. Ed. 986,—opinion rendered by Justice Stone,—the Supreme Court of the United States held, as disclosed in the second branch of the syllabus (70 L. Ed. 986):

> "2. In ascertaining the purpose of the legislature in enacting a statute the court may examine the title of the statute, the source in previous legislation of the particular provision in question, *and the legislative scheme or plan by which the general purpose of the act* is to be carried out."

The Supreme Court of the United States cited the following pertinent authorities in support of this proposition (70 L. Ed. 986, 989): *United States v. Fisher*, 2 Cranch, 358, 386, 2 L. Ed. 304, 313; *United States v. Palmer*, 3 Wheat. 610, 631, 4 L. Ed. 471, 477; *Church of the Holy Trinity v. United States*, 143 U. S. 457, 462, 36 L. Ed. 226, 229.

As stated in *Paul and Mertens Law of Federal Income Taxation*, 1939 Cumulative Supplement, 1387, Section 32A.61:

> "Since this new tax developed a sharp controversy in the course of its passage, and since many of its pro-

> visions are particularly obscure and ambiguous, the Committee reports and to some extent the hearings will be particularly important in the search always to a greater or less degree demanded by a new statute for the congressional intent underlying the language of the Act as finally passed."

See also *Paul and Mertens Law of Federal Income Taxation*, 1939 Cumulative Supplement, 1388-1390. And it is said in an article discussing the 1936 Revenue Act by Homer Hendricks, "The Undistributed Profits Tax," 46 *Yale Law Journal* 19, at page 25:

> "It would seem that since the section (26 (c)(2) 1936 Internal Revenue Act) under consideration was designed to ameliorate a high-rate tax, it should be liberally construed in favor of the taxpayer." (Parenthetical matters ours.)

2. SUMMATION OF ARGUMENT ON LEGISLATIVE INTENT THAT SECTION 26 (c)(2) SHOULD BE LIBERALLY CONSTRUED AS SHOWN BY THE HISTORY OF ITS ENACTMENT.

The Taxpayer has shown that: 1. the basic intent of the 1936 Revenue Act was to tax only *undistributed* profits; 2. the Sub-Committee of the House Ways and Means Committee recommended that some relief be granted corporations bound by contracts to set aside or pay some part of their profits to discharge indebtedness or even in instances where "sound policy" required the retention of dividends by the corporations; 3. it was repeatedly brought to the attention of the House Ways and Means Committee that mortgages similar to Taxpayer's required the setting aside of a percentage of corporate profits for their retirement and that such disposition of corporate profits should be exempt from the undistributed profits surtax; 4. the legislative history of Section 26 (c)(2), cited by the Commissioner, proves only that a compromise was reached in the final bill whereby the taxable year was substituted for a

so-called "dividend" year and profits irrevocably set aside pursuant to the implied or express provisions of a contract entitled the taxpayer to a credit equally as under a contract requiring payment within the taxable year; 5. and, finally, the legislative intent to have the act apply to contracts conforming to the substance of the act and not its technical form is demonstrated by the provision of Section 26 (c)(2), in substance, that a requirement in a contract that a sum equivalent to a percentage of the profits be applied on indebtedness should be held to be the equivalent of a requirement that a percentage of such profits be so applied under Section 26 (c)(2). The foregoing facts are most persuasive evidence that this Court should construe Section 26 (c)(2) liberally, to grant Taxpayer, and taxpayers in the same position, a credit based on the performance of any written contract of indebtedness, the terms of which, under a reasonable construction, require the payment, or setting aside, within the taxable year of 1936, of some portion of their profits for the discharge of such indebtedness.

Taxpayer will further show that the general title of the 1936 Revenue Act, and the sub-titles of those sections thereof imposing a surtax on undistributed profits and granting credit against said surtax for that portion of corporate profits set aside or paid for the discharge of a debt under a written contract, are an additional demonstration of the legislative intent that Section 26 (c)(2) is to be liberally construed, and that this Court should apply that intent towards affirming the decision of the United States Circuit Court of Appeals granting Taxpayer the credit claimed.

3. SECTION 26 (c)(2) SHOULD BE LIBERALLY CONSTRUED IN THE LIGHT OF THE LEGISLATIVE INTENT SHOWN BY THE GENERAL TITLE AND APPROPRIATE SUB-TITLES OF THE 1936 ACT TAXING UNDISTRIBUTED CORPORATE PROFITS; THEREBY ANY DOUBT IS REMOVED IT COVERS TAXPAYER'S CONTRACT.

The intent of the Legislature that Section 26 (c)(2) is to be liberally construed to cover contracts such as the Taxpayer's is further found in the general title of the 1936 Revenue Act and the pertinent sub-titles thereof. Taxpayer first refers to the general title of the Revenue Act of 1936, which reads as follows:

> "AN ACT
>
> To provide revenue, *equalize taxation*, and for other purposes." 6 F. C. A., (1937) Title 26, page 13.

Considering the italicized portion of the general title of the 1936 Revenue Act quoted above in connection with its general purpose to impose a surtax on corporate *undistributed* profits, the intention of Congress is surely signified to treat all corporations who distribute their annual earnings and profits for legitimate purposes alike. It cannot and will not be presumed, Taxpayer is sure, that Congress intended to exempt from this surtax, corporate profits distributed to shareholders and impose the surtax on corporate profits distributed to corporate creditors. The intent to penalize some corporations by imposing a surtax on their profits devoted to the payment of their debts, while exempting from the surtax other corporations whose profits are distributed to stockholders, is indisputably foreign to an act which has for one of its chief purposes the intent to "equalize taxation." Nor will this Court, Taxpayer believes, so construe Section 26 (c)(2) of the Revenue Act of 1936 to penalize Taxpayer because it was inescapably required to pay $46,500.00 on its note and mortgage to the Bank, if by a reasonable construction, Section 26 (c)(2) can be made to apply. Taxpayer will hereinafter show in Subdivision VII, Sections 4, 5 and 6, of its Brief that such

a construction of Section 26 (c)(2) is not only possible, but is in fact a wholly logical one.

The construction of Section 26 (c)(2) of the Revenue Act of 1936 should be consistent with the purpose of that Act,—as shown by its general title,—to "equalize" taxation, as between corporations which, in 1936, distributed their annual earnings to their stockholders, and those other corporations, such as the Taxpayer, which distributed a portion of their annual earnings to their stockholders and also set aside and paid a portion of their earnings to their creditors under compulsion of written contracts.

As stated in *U. S. v. Katz* (1926), 271 U. S. 354, 70 L. Ed. 986,—opinion by Justice Stone,—in the second branch of the syllabus (70 L. Ed. 986):

> "2. In ascertaining the purpose of the legislature in enacting a statute the court may examine the title of the statute, the source in previous legislation of the particular provision in question, and the legislative scheme or plan by which the general purpose of the act is to be carried out."

See also *Maguire v. Commissioner* (1941), 61 S. Ct. 789.

The rule of statutory interpretation, above quoted, was applied in an analogous instance in the case of *McNally v. Field* (1902), 119 Fed. 445. In the McNally case, the court had in issue before it an Act of Congress of March 2, 1901, amendatory to the original Act of June 13, 1898 (U. S. Comp. St. 1901, page 2284), also known as the Spanish War Revenue Act. The Amendatory Act of March 2, 1901, as disclosed by its title was to "reduce taxation" under the original act. The decision of the court, in favor of the taxpayer in that case, was largely influenced by its interpretation of the statute in issue in the light of the announced purpose of the Act as set out in the title. The principle of the case only, and not the facts, are important in this connection. The Court held, illustrative of Taxpayer's contention at page 447 of its opinion:

"Under such circumstances it is not reasonable to conclude that it was the purpose of Congress, in an Act to *reduce* taxation to change the policy which it has followed since the adoption of the War Revenue Act of 1862 * * *. Certainly a conclusion of this character should not be reached *in the absence of a clear and unmistakable intention on the part of congress.* Such a conclusion should rest on a stronger foundation than an interpretation of an ambiguous statute which leads to such a result."

As Taxpayer has heretofore pointed out, since the contracts eligible under Section 26 (c)(2) must have been in existence prior to the passage of that Act and such contracts, therefore, were not formulated to comply therewith, it should be logically presumed that Congress intended in that statute to cover even contracts which were within the reason and substance of Section 26 (c)(2), though not technically conforming to it. *Chess & Wymond, Inc. v. Glenn, Collector,* 40 F. Supp. 666, 670, *ante.* No other construction is, logically, consonant with its announced purpose to "equalize taxation,"—in this instance,—as between corporations declaring dividends to stockholders and corporations setting aside and paying out their profits to retire indebtedness under the obligations of a contract so to do.

Under the authorities quoted above, the cardinal rule of interpretation as applied in this case is that this Court should construe Section 26 (c)(2) herein as applicable to Taxpayer's contract in order to equalize, proportionately, its income tax with that of other corporations who distributed their profits to stockholders,—they being under no contractual compulsion to do otherwise.

Another aid to the construction of Section 26 (c) (2) in respect to its application to the provisions of Taxpayer's note and mortgage, is the sub-title of Section 26 (c) of the Internal Revenue Act of 1936, which reads: "CONTRACTS RESTRICTING PAYMENT OF DIVIDENDS," and the title of sub-

section 26 (c)(2), which is: "DISPOSITION OF PROFITS OF TAXABLE YEAR." 6 F. C. A. (1937) 51, Title 26, Section 26. The titles of these subsections show that Congress intended in the sub-sections following the titles to grant a credit against the surtax imposed on corporate undistributed profits, to the extent such profits were not declared as dividends because of contracts requiring the corporation to otherwise dispose of such profits. In other words, Congress disclosed its intent in the sub-titles of Sections 26 (c) and 26 (c)(2), not to penalize corporations who, because of binding contracts, were unable to escape the surtax by paying out their profits in dividends.

—In case of doubt as to whether the payments from profits made in 1936 on its mortgage and note, in evidence in this case, are a proper basis for its claimed undistributed profits surtax credit, the inference in the Taxpayer's favor from the sub-titles of Sections 26 (c) and 26 (c)(2) should influence the Court to allow such credit,—especially, since Taxpayer, had it not been for such mortgage and note, could have avoided the tax by paying the money in dividends. In the case of *Knowlton v. Moore* (1900), 178 U. S. 41, 44 L. Ed. 969, the United States Supreme Court had under consideration a Federal Revenue Act imposing a tax upon legatees. The court held, in the opinion rendered by Justice White, as disclosed by the second and fourth branches of the syllabus (44 L. Ed. 970):

> "2. The heading to a section of a statute is proper to be considered in interpreting the statute, when ambiguity exists and a literal interpretation will work wrong or injury.
>
> • • •
>
> 4. A particular construction of a statute which will occasion great inconvenience or produce inequality and injustice is to be avoided, if another more reasonable interpretation is present in the statute."

The Supreme Court cited in support of the rule of syllabus 2, the following cases (20 S. Ct. 756): *U. S. v. Fisher*,

2 Cranch, 358, 386, 2 L. Ed. 304, 313; *U. S. v. Palmer*, 3 Wheat. 610, 631, 4 L. Ed. 471, 477; *U. S. v. Union P. R. Co.*, 91 U. S. 72, 23 L. Ed. 224; *Smythe v. Fiske*, 23 Wall. 374, 280, 23 L. Ed. 47, 49; *Coosaw Min. Co. v. South Carolina*, 144 U. S. 550, 36 L. Ed. 537, 12 Sup. Ct. Rep. 689.

Therefore, should any doubt exist from the language of Section 26 (c)(2) as to its application to Taxpayer's note and mortgage, the general title of the Revenue Act of 1936 and the sub-titles of the sub-sections granting a credit in respect to contracts restricting the payment of dividends demonstrate the intent of Congress that said sub-sections should be liberally construed, and such doubt of the Court should be resolved in favor of the credit Taxpayer claims.

Taxpayer now wishes to establish the correctness of the decision of the court below that the pertinent provisions of its note and mortgage fall expressly within the provisions of Section 26 (c)(2) of the Revenue Act of 1936.

4. THE APPROPRIATE PROVISION OF SECTION 26 (c)(2) OF THE 1936 INTERNAL REVENUE ACT AND THE PROVISIONS OF PETITIONER'S NOTE AND MORTGAGE WHICH REQUIRED THE APPLICATION OF FORTY PER CENT. (40%) OF TAXPAYER'S NET EARNINGS IN PAYMENT, WHEN RIGHTLY VIEWED, ARE SYNONYMOUS.

Taxpayer will demonstrate that the decision of the court below is correct and just by showing, first, that the applicable provisions of its note and mortgage fully complied with the provisions of Section 26 (c)(2), and second, that Taxpayer's payment of $46,500.00 out of its 1936 profits on said note and mortgage was in strict performance of the conditions of Section 26 (c)(2) in that respect, as well as of the pertinent provisions of the note and mortgage requiring the application of its 1936 profits to the discharge of its said indebtedness.

It is not disputed in the record in this case, that Taxpayer's contract was executed prior to May 1, 1936, and

that the provisions of the contract in issue expressly dealt with the disposition of earnings and profits of the year 1936, all as required by Section 26 (c)(2) of the 1936 Revenue Act.

It will, of course, be conceded by the Commissioner that the use of the term "net earnings" in Taxpayer's note and mortgage does not make Taxpayer ineligible for the credit claimed under Section 26 (c)(2). Regulations 94, U. S. Treasury Department, Bureau of Internal Revenue, governing the administration of the Revenue Act of 1936, so rules at page 123, as follows:

> "A contractual provision, however, shall not be considered as not expressly dealing with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of 'net income,' 'net earnings,' or 'net profits.'"

The Commissioner also will probably admit, and cannot logically contend to the contrary, that the provisions of Taxpayer's note and mortgage in issue in this case are not included in any of the four types of contractual provisions defined in Treasury Regulations 94, as not conforming to the requirements of Section 26 (c) (2). U. S. Treasury Regulations 94, page 123.

Taxpayer has already demonstrated that the provisions in its note and mortgage (Exs. 2 and 3, OR. 85-102) requiring the payment on said indebtedness of 40% of Taxpayer's annual earnings in every calendar year after January 1, 1934, are paramount to the provisions of said instruments requiring payments to be made in specific amounts on specific dates. Taxpayer's Brief, Subdivision VII, A, 2, *ante*.

Taxpayer is convinced it can clearly show that in every respect, not already specifically demonstrated, Taxpayer's note and mortgage conform to said Section 26 (c)(2). In Subdivision VII, B, Section 7, of Taxpayer's Brief, *post*, Taxpayer will support its contention that it irrevocably set

aside and paid $46,500.00 of its earnings and profits pursuant to its contract and in conformity to Section 26 (c)(2) of the Revenue Act of 1936, and is entitled to full credit accordingly in respect to its 1936 Undistributed Profits Surtax. Taxpayer, in Subdivision VII, B, Sections 8 and 9 of its Brief, *post*, will conclude by quoting and discussing certain precedents and authorities which, it believes, should resolve in favor of Taxpayer's contentions, the slightest remaining doubt in the mind of this Court that Section 26 (c)(2) applies to Taxpayer's note and mortgage and that the decision of the lower court should be affirmed.

5. TAXPAYER'S NOTE AND MORTGAGE REQUIRED IT TO IRREVOCABLY SET ASIDE, IN THE YEAR 1936, FORTY PER CENT. (40%) OF ITS EARNINGS AND PROFITS, TO PAY THAT INDEBTEDNESS IN CONFORMITY TO SECTION 26 (c)(2) OF THE REVENUE ACT OF 1936.

Taxpayer contends, and the tribunals below unanimously held that the provisions of its note and mortgage, requiring it to apply 40% of its net earnings to the payment of its note and mortgage, conform strictly to Section 26 (c)(2) of the Revenue Act of 1936. The most serious question the Commissioner raises as to Taxpayer's note and mortgage—and Taxpayer contends that upon analysis the question resolves itself affirmatively for Taxpayer—is that while Taxpayer was indisputably required to "apply" 40% of its earnings in 1936 on the balance due, if needed, to pay it in full, a provision contained only in Taxpayer's mortgage, provided that "settlement" for amounts of such earnings could be made on April 15, 1937. Ex. 2, OR. 85; Ex. 3, Article I, Section (1), OR. 91. Because of this latter provision of the Taxpayer's mortgage, Commissioner contends that Taxpayer's note and mortgage, although admitted to deal with profits in the taxable year 1936, do not require the payment or irrevocable setting aside of such profits in that year. The court below held to the contrary,—that, giving the words "apply" and

"settlement" their natural meaning in respect to their relation to each other and as intended by the parties to the note to protect the legitimate interests of the Bank and Taxpayer, the conclusion is inescapable that Taxpayer was bound under said note and mortgage to irrevocably set aside the required portion of its earnings to pay that indebtedness within the literal terms of Section 26 (c)(2).

Taxpayer, first, proposes to briefly quote the accepted definitions of the phrase used in Section 26 (c)(2) "irrevocably set aside" and point out certain synonyms which could be properly substituted without altering one iota the scope of Section 26 (c)(2), but which Taxpayer believes will prove its contention. Taxpayer will then set out accepted definitions of the words "apply" and "settlement," show with what meaning, under the circumstances and mutual intent of the parties to said debt, those words were used in Taxpayer's note and mortgage. Having so done, Taxpayer is sincerely convinced that it will have shown its note and mortgage are, in every respect, in conformity to Section 26 (c)(2) of the 1936 Revenue Act.

Taxpayer gives attention, first, to the words of Section 26 (c)(2) which are here specifically in issue: "irrevocably set aside."

Webster's New International Unabridged Dictionary (1934, 2d Ed.) defines the word "irrevocable" as: "Incapable of being recalled or revoked; past recall; unalterable."

Funk & Wagnall's New Standard Dictionary (1935) defines "irrevocable" as: "Not to be changed by the doer or maker."

Webster's New International Dictionary, supra, defines the phrase "set aside" as: "To set apart for a purpose; reserve; as, to set aside part of one's income."

Taxpayer wishes to emphasize the last-quoted definition of the phrase "set aside," as Taxpayer believes it can

establish that the word "apply" can be correctly used to mean the same thing as to "set aside" and that, in order to give effect to both "apply" and "settlement," used in Taxpayer's note and mortgage, the word "apply" must be taken to mean "set aside."

Turning to the authoritative definitions of the word "apply," it appears, as Taxpayer has intimated, to have more than one meaning, either of which might be inferred from that word as used in Taxpayer's note and mortgage, —provided it were not necessary, under the rules governing the construction of contracts, to give equal effect to the word "settlement."

In *Webster's New International Dictionary, supra,* the word "apply" is defined as:

> "To put to use; to use or employ for a particular purpose or in a particular case; *to appropriate,* allot; devote; as to apply money to the payment of a debt."

And similarly in I *Oxford English Dictionary* (1933) 407, the term "apply" is defined as:

> "To put to a special use or purpose, to devote, *appropriate to.*"

And in 1 *Bouvier's Law Dictionary* (3rd Rev.) 214, the word, "application," meaning the act of applying, is defined as:

> "the use or *disposition* made of a thing."

It is Taxpayer's contention that the meaning attributable to the word "apply" as used in Taxpayer's note and mortgage connotes appropriation of Taxpayer's profits in the sense of setting apart or setting such profits aside for future payment. *Webster's New International Dictionary, supra,* supports this meaning of the word "apply" as "to appropriate," in exactly the sense contended for by Taxpayer.

Webster's definition of the word "appropriate" is:

"to set apart for."

And in I *The Oxford English Dictionary, supra,* 407, the word "appropriate" is held to mean:

> "to devote, *set apart,* or assign to a special purpose or use."

Referring back to the definitions just quoted in Taxpayer's Brief, we have shown that the words "set aside" as used in Section 26 (c)(2) also means "to set apart," or "appropriate," which are also synonyms for the word "apply."

Taxpayer, therefore, not only has shown that an authoritative meaning of the word "apply" is to "set apart or set aside," but also will show by undoubted authority that the word "apply" is frequently used in law in such sense in Taxpayer's note and mortgage.

In 3 *Words and Phrases* (Perm. Ed.) 760, in illustrating the meaning of the word "apply," as contended for by Taxpayer, it states:

> " 'Apply,' as used in a statute authorizing a trustee to receive the rents and profits of lands, and 'apply' them to the use of any person means the act of applying, and includes any act of the trustee by which the trust fund is applied for the benefit of the *cestui que trust,* whether expressly directed by the donor or permitted according to the discretion of the trustee; and hence a will creating a trust to receive rents and profits of land and pay them over to the beneficiary is valid. *Leggett v. Perkins,* 2 N. Y. (2 Comst.) 297, 309."

And in the same volume of 3 *Words and Phrases* (Perm. Ed.) 457, it also is said:

> " 'Applied,' as used in a will directing that a specific portion of rents, issues, and profits shall be 'applied' to the education and support of testator's children during their minority, is substantially equivalent to

'paid over.' *Moorehouse v. Hutchinson*, 2 N. Y. Suppl. 215, 217."

In both the examples given above from *Words and Phrases*, the courts construed the word to mean, first, the receipt of money, and, second, its irrevocable setting aside for a future payment when the contingency, as defined in the instrument under construction, arose. So, in the case at bar, Taxpayer has shown the circumstances surrounding the future performance of Taxpayer's note and mortgage which made it the intent of the parties that Taxpayer was irrevocably obligated to set aside its net earnings or profits amply equivalent to guarantee that upon the happening of the contingency of an accurate determination of Taxpayer's profits for the calendar year, forty per cent. (40%) of said accrued profits would be available and paid on said indebtedness—the time of said determination and payment not to be later than April 15th of the year following that in which said profits were earned.

As the next logical step in the discussion of this question, Taxpayer refers to the accepted definitions of the word "settlement." In this connection, it is stated in 39 *Words and Phrases* (Perm. Ed.) 33:

> " 'Settle' is said to be a word of equivocal meaning; and to mean different things in different connections, and that the particular sense in which it is used may be explained by the context or the surrounding circumstances. Accordingly, the term may be employed as meaning to agree, to arrange, to ascertain, to come to or reach an agreement, *to determine*, to establish, to fix, to free from uncertainty, to place, or to regulate. *Edwards v. Edwards*, Tex. Civ. App., 52 S. W. (2d) 657, 661."

The word "settlement," as used in Taxpayer's mortgage (Ex. 3, Article I, Section (1), R. 91), Taxpayer believes, is used in the sense of a final determination,—acceptable to the Bank,—of the amount in dollars of forty per cent. (40%) of the net earnings of the Taxpayer for the

preceding year,—less any payments theretofore made out of said profits,—and the payment over to the Bank of the net balance due. "Settlement" is defined in this sense in 39 *Words and Phrases* (Perm. Ed.) 35, as:

> "The word 'settlement' is defined as the act or process of adjusting or determining; an adjusting; an adjustment between persons concerning their dealings or difficulties; an agreement by which parties having disputed matters between them reach or ascertain what is coming from one to the other; arrangement of difficulties; composure of doubts or differences; determination by agreement; and liquidation. *Sowers v. Robertson*, 58 P. (2d) 1105, 1107, 144 Kan. 273."

And in 39 *Words and Phrases* (Perm. Ed.) 42, the word "settle" is defined as:

> "A promise to 'settle' a liquidated demand, respecting which there was no dispute between the parties, is a promise to pay the same."

And in 3 *Bouvier's Law Dictionary* (3rd Revision, 1914), 3054, "settlement" in contracts is defined as "payment in full."

Taxpayer wishes to again recall to the Court the circumstances under which the words "apply" and "settlement" were used in the provisions of the note and mortgage in issue. These circumstances impel the inevitable conclusion that the terms "apply" and "settlement" were advisedly used in the exact sense contended for by Taxpayer and likewise, entirely consonant with the sense in which "irrevocably set aside" is used in Section 26 (c)(2).

The Taxpayer has heretofore shown that it was the deliberate requirement of the Bank and the bondholders whom it represented, that a large percentage of the prospective earnings of the Taxpayer be pledged under the note and to forfend against, as far as possible, the bondholders having again to take back and dispose of,—to their sorrow,—the plant and equipment purchased by Taxpayer, in order to recoup their investment. OR. 38. Taxpayer's

brief, subdivision VII, A, 2; *ante*. While the Taxpayer was indisputably willing to accede to this requirement,—as evidenced by the completed contract,—both Taxpayer and the Bank were cognizant that as an industrial concern, Taxpayer's net earnings could not be accurately determined and the performance of the contract, in this respect, practically consummated, until a physical inventory of its assets, including large amounts of raw materials, goods in process, and finished goods, had been taken.

This will, of course, be conceded by the Commissioner. In Article 22(c)-1 of United States Treasury Department, Regulations 94, governing the administration of the Revenue Act of 1936, page 38, it states:

> "NEED OF INVENTORIES.—In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary in every case *in which the production, purchase, or sale of merchandise is an income producing factor*. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale. Merchandise should be included in the inventory only if title thereto is vested in the taxpayer. Accordingly, the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment, but should exclude from inventory goods sold, title to which has passed to the purchaser. A purchaser should include in inventory mechandise purchased, title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery, transfer of title to which has not yet been effected."

Article 22 (c)-2 provides:

> "VALUATION OF INVENTORIES.—Section 22 (c) provides two tests to which each inventory must conform:

(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and

(2) It must clearly reflect the income.

• • •

An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as *clearly reflecting his income.*" Regulations 94, pp. 38 and 39.

It will be further noted as establishing the importance of a physical inventory in accurately determining the net income of an industrial concern that U. S. Treasury Regulations for the preparation of inventories of concerns such as Taxpayer's require four closely printed pages. U. S. Treasury Regulations 94, pp. 38 to 42.

Taxpayer, also, again refers, in support of its contention as to the reason for this provision regarding "settlement" in its note and mortgage, to the testimony of Sidney J. Collins, Taxpayer's auditor, that it was and is an utter impossibility for the Taxpayer to have computed its net profits with sufficient accuracy to constitute a performance of any contract that required the payment of a percentage of the year's earnings at the close of the last working day in that year. PR. 24, *et seq.* Taxpayer's Brief, subdivision VII, A, 1, *ante.*

Congress was thoroughly informed of the fact that annual profits of manufacturing concerns could not be accurately determined within the year earned when it was considering the Revenue Act of 1936. For illustration, Taxpayer refers to the testimony of Mr. Scott Russell, representing the Cotton Textile Institute, who testified as shown in the report of Hearings Before The Senate Finance Committee on the Revenue Act of 1936, 380, at page 385:

"May I, Senator, just indulge in one more statement with reference to this question? The Treasury

> Department has always recognized, and now incorporates in regulation 86, article 22, the statement that no mill, no business in which the manufacture of goods is an income-producing factor, can possibly show a correct income without the use of inventories."

Taxpayer also refers to the testimony of Honorable Arthur A. Ballantine, former Assistant Secretary of the Treasury on this subject, as set out in said Report of Hearings Before the Senate Finance Committee on the Revenue Act of 1936, 415, at page 417, where Mr. Ballantine states:

> "Unless there is a period after the close of the taxable year, the year for which we are determining the income, in which the corporation can determine its distribution, I do not see how this measure could possibly work at all, because at the end of a year there are all kinds of adjustments, in many corporations which have to be made. Then when they finally take and look at their inventories, they go over their accounts receivable, they look ahead at their problems, and they cannot make an accurate determination within the year. There must be some period in practical experience after the close of the year for any enterprise of any size to determine its income."

Taxpayer contends that since the attention of Congress was repeatedly called to the impossibility of computing annual profits within the year at the time Section 26 (c)(2) of the 1936 Revenue Act was being considered, it, undoubtedly, intended that under Section 26 (c)(2) a contract that implicitly required an irrevocable setting aside of profits for payment would equally conform to the statute as a contract which expressly required *payment* of profits on an indebtedness within the taxable year. Taxpayer has shown in its Brief, subdivision VII, B, 5, *ante*, that the requirement to apply 40% of its profits is the equivalent to "irrevocably setting aside" such profits.

Returning to the circumstances under which the words in issue were inserted in Taxpayer's note and mortgage, it

is to be presumed that Taxpayer's accountant was called in for advice as to these important provisions of the contract, as he was in regard to the performance thereof (PR. 23-24), and that his advice was followed, resulting in the insertion of the provision extending the maximum time of determining profits for the preceding year and making payment accordingly to April 15th of the following year.

Likewise, keeping in mind the paramount purpose of the Bank and the bondholders it represented, that 40% of the profits should be irrevocably segregated for the payment of the note and mortgage, the Bank would naturally insist that,—notwithstanding, it would be impossible to determine the net profits until subsequent to the end of the year in which they accrued,—that such provision must be made in the mortgage as would require Taxpayer to earmark and irrevocably set aside sufficient earnings to assure that when the determination of profits was made, Taxpayer's profits would be available to pay the amount so determined due the Bank. Barring the use of the words "irrevocably set aside," which, in this connection, would have removed the claim of Taxpayer in this case from the realm of any controversy, what better term in law than that of "apply" could have been used to carry out the undoubted intent of the Bank to hedge its claim to 40% of the profits with every practicable safeguard of language,—in view of the necessity of waiting for actual payment of the profits for any year until after that year had expired. As Taxpayer has shown, the word "apply" has been repeatedly used to impose an obligation upon trustees,—whose obligations are the highest known to law,—to segregate funds and, thereafter, pay such funds upon the happening of a future event to the *cestui que trust*. Taxpayer's Brief, subdivision VII, B, 5, *ante*. It is submitted that the function of the Taxpayer under this obligation was analogous to that of a trustee, obligated to preserve a fund for future payment,—until Taxpayer's earnings for the

year were accurately determined, the amount due finally settled and paid over,—and that the word "apply" was the best possible word to have used to impose that obligation. Taxpayer's Brief, subdivision VII, B, 6, *post*. To draw together the definition of the words, "irrevocably set aside," used in Section 26 (c)(2) and the natural and inescapable meaning of the word "apply," we refer to an illustration of the use of the words, "set apart" in the same sense as we have shown the word "apply" is used, in 39 *Words and Phrases* (Perm. Ed.), page 7, which states:

> "Text-writers, in using the terms 'set aside,' 'set apart' and 'actually set apart' with reference to dividends, proceed on the theory that the act of declaring a dividend, operating, as it does, as an actual severance of the dividend from the stock and corpus of the corporate property, is *ipso facto*, in and of itself, the setting apart, setting aside, and segregating such dividend in the sense that it creates an immediate right of the stockholder to demand and recover the same when due. * * *." *McLaren v. Crescent Planing Mill Co.*, 93 S. W. 819, 822, 117 Mo. App. 40.

Applying a practical test to Taxpayer's construction of the obligation imposed upon Taxpayer by the word, "apply," can it be supposed for one moment that the Bank would in the mortgage and note leave a loophole whereby the Taxpayer under that contract had any option to make any disposition of its profits and earnings as they accrued during the year, which would, in the slightest degree, prejudice the Bank's receipt of 40% of said profits on said note and mortgage,—consonant with the necessity of delay until a determination of the profits could be accurately made? The argument of the Commissioner at page 18 of his brief that Taxpayer was free to use this percentage of earnings for purchase of new equipment or investment is a direct contradiction of and proof of, the Commissioner's statement immediately following, in substance, that Taxpayer was legally obligated to maintain the fund

for the creditors. The answer to the claim of the Commissioner that the fund could be used to purchase equipment or for permanent investment, Taxpayer submits, is inescapably no, and that every intendment of the contract is that the necessary portion of the profits required to secure performance of this obligation be irrevocably segregated until paid to the Bank.

The obligation was "The Company will apply forty percentum (40%) per annum of its net earnings, etc." Taxpayer's note and mortgage does not even leave the loophole of language such as used in Section 26 (c)(2) heretofore quoted, reading so far as pertinent:

> "an amount *equal* to a percentage of earnings and profits, etc."

In short, how can it be consistently contended by the Commissioner that if the irrevocable setting aside of "an amount equal to a percentage of earnings and profits, etc." shall be considered a requirement to pay or set aside such percentage of earnings and profits within the terms of Section 26 (c)(2), that the direct obligation of Taxpayer to "apply" is not also, and equally, an obligation to irrevocably set aside the earnings so governed? Taxpayer submits there is no answer but that the obligation imposed on Taxpayer, to apply 40% of Taxpayer's earnings, is an obligation to irrevocably set aside 40% of its earnings in the taxable year 1936 to discharge said indebtedness.

Summarizing, therefore, this subdivision of Taxpayer's Brief, Taxpayer contends that it has shown that because of the practical necessities of the situation, in which both the Bank and Taxpayer were, when this note and mortgage in issue were entered into, the word "apply" was used in an advised and considered sense to impose a trustee-like obligation upon the Taxpayer to "irrevocably set aside" 40% of its profits or earnings within the taxable year 1936, in strict conformance to the terms of Section 26 (c)(2) of the Internal Revenue Act of 1936.

6. TAXPAYER'S OBLIGATION TO APPLY 40% OF ITS 1936 PROFITS ON ITS MORTGAGE INDEBTEDNESS, FINAL SETTLEMENT TO BE MADE IN THE SUCCEEDING YEAR, RAISED AN IMPLIED OR CONSTRUCTIVE TRUST IN RESPECT TO SUCH PROFITS REQUIRING AN IRREVOCABLE SETTING ASIDE THEREOF, CONFORMING TO SECTION 26 (c)(2).

Taxpayer has previously shown in its brief, subdivision VII, B, 5, that the provisions of its note and mortgage requiring it to apply 40% of its net earnings on its note and mortgage indebtedness, required it to irrevocably set aside such portion of its profits. Its exact legal function is construed to be that of a trustee. The violations of the Taxpayer of such obligation would, under the mortgage, have resulted in a default and consequent severe penalties as follows:

1. The declaration of the entire remaining unpaid principal due and payable.

2. Suit for such balance and interest, together with further interest at the rate of 6% per annum.

3. Sale at public auction of the entire plant and equipment of the Taxpayer, at its expense, including all attorney and counsel fees.

4. Entry into possession by the Bank of the Taxpayer's plants and equipment and the exclusion therefrom of the Taxpayer's officers and agents, with exclusive right in the Bank to thereafter collect all income, rents, issues, and profits of such property.

5. Any other remedy allowed by law or equity against the Taxpayer, in addition to any of or all of the foregoing. Taxpayer's Mortgage, Ex. 3, Art. IV, PR. 35-37.

An analogous situation was presented in *Marine Midland Trust Co. v. Alleghany Corporation* (D. C. N. Y. 1939), 28 F. Suppl. 680, wherein the Alleghany Corporation had agreed in a bond indenture to secure its obligation with

collateral at all times during the life of the indebtedness, to the value of 150% of the principal amount of the outstanding bonds. The court held that this contract right was enforceable in equity by a suit for specific enforcement. Certainly, an equitable obligation having been imposed on the Taxpayer by the provisions of the note and mortgage requiring 40% of its net earnings to be applied on the indebtedness, an equitable lien in favor of the Bank was imposed upon such percentage of its earnings. See also *Commissioner v. Strong Mfg. Co.* (1941), 124 F. (2d) 397; I *Restatement of the Law of Trusts*, 32, Section 10a.

Applying the principle developed, the conclusion follows that Taxpayer was the Trustee of 40% of its 1936 profits which it was irrevocably required to set aside for the discharge of its note and mortgage.

Taxpayer will now show that Taxpayer irrevocably set aside within the taxable year 1936, $46,500.00 for the discharge of its said indebtedness and paid it thereon in conformity to its contract and to Section 26 (c)(2) of the 1936 Revenue Act, and that Taxpayer is thereby clearly entitled to the income tax credit it claims under said section.

7. TAXPAYER, IN 1936, UNDER THE OBLIGATION OF ITS WRITTEN CONTRACT, IRREVOCABLY SET ASIDE $46,500.00 OF ITS 1936 PROFITS FOR THE PAYMENT OF ITS NOTE AND MORTGAGE HELD BY THE CENTRAL UNITED NATIONAL BANK OF CLEVELAND.

Taxpayer contends that in setting aside and, admittedly, paying $46,500.00 out of its 1936 profits, in discharge of its note and mortgage, it conformed to Section 26 (c)(2) of the 1936 Revenue Act, as well as to the obligation of its contract. The profits of Taxpayer as shown by its 1936 Income Tax Return were $126,786.04. Ex. 1, OR. 67. Forty per cent. (40%) of said profits is $50,714.42. The balance due on Taxpayer's note and mortgage as of January 1, 1936, was $47,000.00, plus interest. OR. 39. The items of interest paid in 1936 by Taxpayer are not in dispute here,

as the Commissioner has already allowed due credit on Taxpayer's 1936 income tax therefor. As Taxpayer has shown, it was under strict obligation to irrevocably segregate, and did segregate, forty per cent. (40%) and more of its profits as they accrued during the year 1936, until it had paid off said note and mortgage. Taxpayer not only set aside, irrevocably, from its profits earned in 1936 the amount needed to discharge its note and mortgage, but also, in 1936, paid over the money to the Bank. Such payment was utterly consistent with Taxpayer's obligation to irrevocably set aside that amount for such purpose. No segregation by Taxpayer of said profits for such purpose could be as irrevocable as actual payment to the Bank. Taxpayer was amply justified in so doing, for its profits on September 30, 1936, estimated with the best possible degree of approximation,—and barring any losses in the rest of the year which would cancel such profits,—were $86,000.00. OR. 46. Having in mind additional savings in interest that might be effected by anticipating the maximum due date of principal payments, the forgiveness of $500.00 on the principal, which the Bank agreed to allow, when approached on the subject, and the further savings in income tax which could be effected under Section 26 (c)(2), Taxpayer took counsel with its attorney and its auditor. PR. 24. In addition to the profits mentioned, it appeared in September of 1936 that Taxpayer had *orders* on its books in the total amount of $100,000.00. OR. 44. Weighing all these facts, and particularly to fulfill every possible intendment of Section 26 (c)(2), Taxpayer's attorney and accountant advised that payment be made of the balance due on Taxpayer's note and mortgage. Taxpayer's auditor, Sidney J. Collins, C. P. A., testified as to these conferences and conclusions, as set out on page 24 of the Record, as follows:

> "Q. Was there any conference prior to the payment of these sums or any part of these sums by the Strong Manufacturing Company to the Central United National Bank on which your advice was asked?

A. Yes. In September of 1936 the President and Treasurer of the company and their counsel, Mr. Morgan, invited us to a conference on the question of the payment of the mortgage and its requirement under this contract. There were several discussions with other attorneys on the point, and the Treasurer showed the profits to September 30th, which we checked on the books, and they also—that is, the Treasurer submitted evidence of future earnings for the balance of that year. Insofar as it is possible, we determined this, reported to the company officials our estimate that profits would be in excess of forty per cent. *That, of course, would be subject to something that might happen during the year after September 30th.* However, it was our recommendation that since the profits were to be such that forty per cent, being in excess of the requirements of this contract, if they were able financially to do so, that they would pay during the year on the contract. Does that answer your question?"

In other years Taxpayer had been less fortunate, having been forced to obtain a written extension from the Bank of its payments due in the year 1934, in order to preserve its working capital needed for its business. OR. 40. It will be noted in connection with the provisions of the note and mortgage in controversy that said extension provided, in its first paragraph, that it was granted

"with the understanding, however, that such extension shall not be construed as a waiver of any subsequent defaults." *Ex. 4, paragraph 1, OR. 102.*

See also Ex. 3, Article IV, Section 2, PR. 35, providing that no waiver by the Bank of any default shall be construed as a waiver of any subsequent default.

Section 26 (c)(2) provides,—pertinent to the performance of its terms that specifically entitle Taxpayer to the claimed credit as against its corporate surtax,—that Taxpayer is entitled to such credit "to the extent that such amount has been so paid or set aside," for the discharge of said indebtedness. Taxpayer contends that its 1936 profits, in the amount of $46,500.00, so paid in discharge of

its indebtedness had, until payment, been irrevocably set aside for that purpose,—otherwise, obviously said "net earnings" could not have been available. It is undisputed in the Record that all payments in 1936 were made out of earnings. OR. 44-45. Finally, Taxpayer points out that the credit granted by Section 26 (c)(2) under Taxpayer's qualifying contract is based on amounts which are "set aside *or* paid out," so that Taxpayer is eligible whether it is held to have irrevocably set aside the profits in 1936 *until* paid to the Bank, or by reason of the actual payment of the note and mortgage—both acts having been fully completed in the taxable year of 1936.

Summarizing, therefore, Taxpayer has shown that the payment of $46,500.00 out of its profits in 1936 to discharge its note and mortgage was less than 40% of its earnings of that taxable year; that said payment was literally and in substance in strict performance of a provision of a written contract dealing with earnings, requiring Taxpayer to irrevocably set aside said profits until paid in the discharge of an indebtedness, and that Taxpayer's note and mortgage, being in conformity to Section 26 (c)(2), the performance thereof by Taxpayer met the requirements of that statute in, first, irrevocably setting aside $46,500.00 of its profits and, second, in paying said amount to its debtor,—either of which acts entitles it to the credit claimed,—Taxpayer having performed both acts within the taxable year, 1936.

Taxpayer sincerely believes that it has demonstrated that the provisions of its note and mortgage, and its performance thereof within the taxable year 1936, in issue here, clearly entitles it to the credit claimed in respect to its corporate surtax under Section 26 (c)(2) of the 1936 Revenue Act. Any further doubt as to the propriety of Taxpayer's claim should be resolved in its favor under the rules of interpretation of the Federal Tax Statutes announced by the courts and the precedents construing Section 26 (c)(2), hereinafter set forth.

8. SECTION 26 (c)(2) OF THE 1936 INTERNAL REVENUE ACT SHOULD BE GIVEN A COMMON SENSE AND PRACTICAL CONSTRUCTION ACCORDING TO ITS INTENT, AND TAXPAYER'S CONTRACT SHOULD BE INTERPRETED, IF NECESSARY, BY ITS SUBSTANCE AND NOT ITS FORM, TO RELIEVE TAXPAYER FROM THE UNDOUBTED HARDSHIP OF THE COMMISSIONER'S DEFICIENCY ASSESSMENT.

Taxpayer, in this section of its Brief, contends that under the controlling authorities, hereinafter set out, the Court should construe Section 26 (c)(2) and the pertinent provisions of Taxpayer's note and mortgage in accordance with the realities of the situation, as reflected in the record herein. These demonstrate, Taxpayer believes, that Taxpayer was bound to irrevocably segregate its profits in the year 1936 to the extent necessary to discharge that indebtedness, and that such was done. No technical construction of Section 26 (c)(2) should be allowed to govern when a common sense interpretation shows,—as Taxpayer sincerely believes it does,—that that statute is affirmatively applicable to the fact situation in this case. The substance of Section 26 (c)(2) and the appropriate provisions of Taxpayer's note and mortgage should be determinative according to their substance, and not to some particular form they are conceived to take to the contrary.

It is the undoubted intent of Congress, as shown in Taxpayer's Brief, Subdivision VII, B, 1 and 2, that Section 26 (c)(2) be liberally construed to grant the relief thereby intended, and every doubt which arises should be resolved in favor of such legislative intent,—to relieve Petitioner under the facts in this case, from a high surtax which was intended to be assessed *only* on undistributed profits. In support of Taxpayer's contention, it cites the case of *Ruben v. Commissioner of Internal Revenue* (1938), 97 Fed. (2d), 926 (8th Circ.). In the *Ruben* case, the Commissioner of Internal Revenue sought to levy an income tax under the Revenue Act of 1928, Section 115 (a), based

on a release of the taxpayer from asserted claims against him in a large amount, it being contended by the Commissioner that this release constituted taxable income equal to the claims asserted. It was established that the taxpayer had, in fact, received no actual income from the transaction. The court in the *Ruben* case set aside the deficiency assessment and held, in the *first branch of the syllabus*, at page 926:

> "Taxation is a practical matter dealing with reality."

So, in this case, it is sought to levy a tax on a *distributed* portion of Taxpayer's 1936 earnings, when the tax, to all intents and purposes, was enacted to reach only undistributed profits. Dealing with the realities in this case Taxpayer contends the presumption should be against the tax on the distributed portion of Taxpayer's 1936 earnings in issue herein.

The contention of the Commissioner in this case is neither in accord with common sense nor standard business practice, as applied to Taxpayer's note and mortgage. The Commissioner must admit that it was, in fact, impossible for Taxpayer, in any year, to accurately compute its profits without taking an inventory after the close of business in that year. It was, therefore, necessary for Taxpayer to have this saving clause in the mortgage, which allowed a final "settlement" of the amount due by way of earnings to the Bank within a reasonable period after the close of the year,—and until April 15th of the succeeding year certainly defined such a reasonable period. No corporation would risk the imposition of the severe penalties and forfeitures contained in the mortgage in this case by permitting to be inserted therein a condition as to the payment of profits within the year earned, which was impossible of performance. Nevertheless, the terms of Taxpayer's note and mortgage, according to usual business standards, clearly earmarked 40% of Taxpayer's earnings

as they accrued, for payment on said obligation *when* the profits were determined. Taxpayer would not consider subjecting the corporation to the before-mentioned forfeitures and penalties, by taking any other view as to the requirement to "apply" said portion of the profits than that an ample portion of the profits must be set aside irrevocably to assure the strict observance of the future obligation to pay it after an accurate determination of the amount of 40% of the annual profits of the corporation had been made. The rule of common sense interpretation and that of the standard of accepted business practice has been held to apply to taxation statutes by controlling authorities. For illustration, Taxpayer refers to the case of *Rhodes v. Commissioner of Internal Revenue* (1939), 100 Fed. (2d) 966, at 969, in which the Court held:

> "Common sense interpretation is the safest rule to follow in the administration of income tax laws. Gross income and deductions flow from trade, commerce and dealings in property carried on in the ordinary business way and in the determination of taxes men should measure both by ordinary everyday business standards. Compare *Woolford Realty Co. v. Rose, Collector*, 286 U. S. 319, 332, 52 S. Ct. 568, 76 L. Ed. 1128, *United States v. Hardy*, 4 Cir. 74 Fed. (2d) 841."

And in the case of *Wesch v. Helburn* (1933), 5 F. Supp. (Dis. Ct. of Ky.) 581, Judge Dawson held, as disclosed in the first branch of the syllabus:

> "1. Reasonable and practical construction should be given to statute relating to deductions in computing income tax."

In that case a deduction was allowed the taxpayer, based on the utter worthlessness of stock in a notoriously insolvent corporation, although it was undisputed that in the year for which the deduction was claimed the stock had been sold in considerable blocks, although at only a few cents a share. A technical construction of the statute there in-

volved would have, of course, brought the opposite judgment by the court.

In the case of *Commissioner of Internal Revenue v. Ashland Oil and R. Co.* (1938), 99 Fed. (2d) 588, at page 591, the court said:

> "It has been said too often to warrant citation that taxation is an intensely practical matter, and that the substance of the thing done and not the form it took, must govern. This principle has been repeatedly invoked by the Commissioner and applied by the Board. *Carter Publications, Inc. v. Commissioner,* 38 B. T. A. 160; *Warner Co. v. Commissioner,* 26 B. T. A. 1225; *George Whittell and Co., Inc. v. Commissioner,* 34 B. T. A. 1070."

And in headnote three, the court held in the *Ashland Oil and R. Co.* case, at page 588:

> "Taxation is an intensely practical matter and the substance of the thing done and not the form it took must govern, as regards liability for income tax."

Petition for writ of certiorari was denied in this case. 58 S. Ct. 786, 83 L. E. 1057, 306 U. S. 661.

All doubt in the interpretation of Section 26 (c)(2) and of Taxpayer's contract should be resolved in favor of the Taxpayer. *Hasset v. Welch* (1938), 303 U. S. 303, 58 S. Ct. 559; *McFeely v. Commissioner of Internal Revenue* (1935), 296 U. S. 102, 56 S. Ct. 54; reh. den. 296 U. S. 664, 56 S. Ct. 304; *Old Colony R. Co. v. Commissioner of Internal Revenue* (1932), 52 S. Ct. 211, 284 U. S. 552; *U. S. v. Merriam* (1923), 263 U. S. 179, 44 S. Ct. 69; *Gould v. Gould* (1917), 245 U. S. 151, 38 S. Ct. 53; *Glenn v. Oertel* (1938), 97 Fed. (2d) 495 (6th Circ.).

It is equally well established that Taxpayer's note and mortgage should be construed according to the substance of Section 26 (c)(2), and not according to the literal words of the statute,—especially, since the statute applies to contracts entered into before its enactment, and it was

not intended to cover future contracts drafted in contemplation of its benefits. *Cooper v. Reynolds* (1932), 60 Fed. (2) 650 (Dist. Ct. of Wyo.), affirmed in *Reynolds v. Cooper* (1933), 64 Fed. (2d) 644 (10th Circ.), which was, in turn, affirmed in 291 U. S. 192, 54 S. Ct. 356. *Chess & Wymond, Inc. v. Glenn, Collector,* 40 F. Supp. 666, *ante.* As Taxpayer has repeatedly emphasized, Congress must have intended a liberal construction of Section 26 (c)(2) in order that it should apply to all contracts conforming in substance thereto, since, by its terms, it could not apply to contracts formulated with a view to obtaining the benefits of provisions of said Section 26 (c)(2), and also because Congress, as Taxpayer has shown, had mortgages and notes of the kind illustrated by Taxpayer's in mind when it enacted Section 26 (c)(2), and finally, both because of the purpose of Congress to equalize taxation,—as stated in the general title of the 1936 Revenue Act,—and its intent to exempt distributed income, as shown by the sub-titles of Section 26 (c) and Section 26 (c)(2). See Taxpayer's Brief, Subdivision VII, B, Sections 1 and 2. In the case of *Helvering v. Stockholms Enskilda Bank* (1934), 293 U. S. 84, 55 S. Ct. 50, the United States Supreme Court held, as disclosed in the seventh, eighth, and ninth branches of the headnotes (55 S. Ct. 50) as follows:

> "7. Taxing acts are not to be extended by implication beyond clear import of language used, and doubts are to be resolved against government and in taxpayer's favor.
>
> 8. Lawmaker's intention controls in construing taxing acts.
>
> 9. Lawmaker's intention in enacting taxing act is to be ascertained, not by taking word or clause from its setting and viewing it apart, but by considering it in connection with context, general purpose of statute, occasion and circumstances of its use, and other appropriate tests for ascertainment of legislative will."

It surely will be conceded by the Commissioner that it works an unusual hardship on Taxpayer to pay a high rate surtax,—which was assessed generally to penalize only *undistributed* corporate profits,—for no better reason than that Taxpayer was required under threat of the penalties in its mortgage, constituting complete forfeiture of its corporate existence, to pay to the extent of $46,500.00 of its 1936 profits in discharge of said indebtedness. Taxpayer submits that such a result was clearly not intended by Section 26 (c)(2). If there be any doubt in the mind of the Court that Taxpayer is entitled to the credit claimed, it should be resolved against the deficiency assessment made by the Commissioner and in favor of the credit asserted by Taxpayer, because of the inherent hardship of the tax. *Helvering v. Hutchings* (1941) 61 S. Ct. 653; *Reconstruction Finance Corp. v. Prud. Secs. Advisory Group* (1941) 61 S. Ct. 331; *Harrison, Collector v. Schaffner* (1941) 61 S. Ct. 759.

The statement of the case by the court below is most convincing. Speaking through Judge McAllister it said:

> "With reference to the object of the statute to equalize taxation, it cannot be said that the resulting inequality of taxation, as contended for on behalf of the Commissioner, is consonant with such expressed purpose. There appears to be no reason founded on principles of fair dealing, accounting methods, ordinary business practice, or common sense, that would justify the unreasonable, capricious, and discriminatory plan of taxation, here sought to be established as the statutory law; and, in this case, in the absence of a clearly expressed intention to the contrary, it must be held that Congress did not intend to work inequality, injustice, and hardship, nor was it intended that the statute would have this meaning and effect.
>
> We are of the opinion that, in accordance with the legislative intent, the contract, requiring the corporation to 'apply' 40% of its earnings for any calendar year to the payment of indebtedness in such year, is encompassed by the requirement of Section 26 (c) (2)

of the Revenue Act of 1936; and such application is equivalent to setting aside, irrevocably, profits within the taxable year for the discharge of a debt, and entitles the taxpayer to credit."

Following the rules of statutory construction and the rules equally governing the construction of Taxpayer's contract for taxation purposes set out above, Taxpayer expresses its sincere conviction that the deficiency assessment of the Commissioner asserted here is wholly unjust, contrary to the intent of the Legislature and finally, to the facts in this case, and the decisions of the Board of Tax Appeals and of the United States Circuit Court of Appeals disallowing it, should be affirmed.

9. COURT AND BOARD OF TAX APPEALS DECISIONS AFFIRM THE RIGHT OF TAXPAYER TO A CREDIT UNDER SECTION 26 (c)(2).

The decisions construing Section 26 (c)(2) of the 1936 Revenue Act granted a credit against the 1936 Undistributed Profits Surtax in the case of contracts such as Taxpayer's, where a reasonable construction of the contracts imported a definite obligation to pay, or irrevocably set aside a portion of corporate profits during 1936 and such obligation had been performed. The Commissioner here, as in the cases cited, has contended that the contracts and their performance must technically conform to the statute. The decisions have repudiated this view, and Taxpayer believes, properly, in favor of a reasonable construction of that Section.

G. B. R. Oil Corporation v. Commissioner (1939), 40 B. T. A. 738, affirmed without opinion 124 F. (2d) 396, was an early case decided by the Board of Tax Appeals under Section 26 (c)(2) of the Revenue Act of 1936. The taxpayer in that case borrowed money from a bank, in 1934, to purchase several oil leases and, in turn, was required to execute a deed of trust liens on the leased prop-

erties and written assignments to the bank of all the proceeds from the oil produced therefrom. In 1936 all of the money received from the leases was deposited in the bank, but the taxpayer was permitted to withdraw funds for current expenses and also for new developments. The Board said (40 B. T. A. 743):

> "In determining whether the claimed credit of a corporate taxpayer falls within section 26 (c)(2) and the regulations promulgated thereunder, three things seem to be necessary:
>
> "(1) There must be a written contract executed prior to May 1, 1936, which expressly deals with the disposition of earnings and profits of the taxable year.
>
> "(2) The credit relates to that portion of the earnings or profits which are required to be paid or irrevocably set aside in the discharge of a debt.
>
> "(3) The credit is allowable to the extent that the money has been so paid or set aside."

With respect to the first requirement the Board held that the fact that the year 1936 was not specifically mentioned in the assignments did not prevent the granting of the credit.

With respect to the second requirement the Board said that the fact that the bank permitted the taxpayer to use enough of the assigned funds for its current developments and operating expenses did not affect the validity of the assignment of all of the earnings.

With respect to the third requirement the Board held that the fact that the payments exceeded the petitioner's net taxable income did not affect the question because the net taxable income was probably reduced by depletion allowances. The Board of Tax Appeals in allowing the credit petitioned for by the G. B. R. Oil Corporation, concluded (40 B. T. A. 744):

> "The general purpose of section 26 (c)(2), it seems to us, is to give a credit where a dividend paid credit can not be secured. In other words, *the basic intent*

of Congress seems to have been to include in the provision only contracts which inevitably require in their performance a drawing on current earnings, thus removing current earnings as a source of dividend payments. See *Paul and Mertens*, par. 32 A. 46, 1938 cumulative supplement.

Respondent in his brief cites no authority in support of his contention, but, after quoting the language of the assignments from petitioner to the bank, says:

'We are unable to find in these contracts or assignments any provision which expressly deals with the disposition of petitioner's earnings and profits of the taxable year.'

It is true, as we have already said, that the assignments in question do not expressly refer to 'earnings and profits' as such, but they certainly do require that all of petitioner's gross receipts from these properties be paid to the bank and that would certainly include 'all earnings and profits' from them.

Respondent says in his brief that petitioner 'could have declared a dividend out of its earnings and profits of the taxable year and paid same with borrowed money, notes, credits, or in stock.' Perhaps it could have done so. We do not consider that is a matter which we have to decide. Even assuming that it is so, we do not see where that fact affects the application of the credit provided by section 26 (c)(2). We sustain petitioner in this assignment of error."

The decision of *G. B. R. Oil Co. v. Commissioner*, 40 B. T. A. 738, was cited and followed by the District Court of the United States for the Eastern District of Virginia in *Chesapeake Ferry Co. v. Early* (Memo. Op.), 39-2 U. S. T. C. 10923, par. 9786.

The issue in *Michigan Silica Company v. Commissioner* (March 5, 1940), 41 B. T. A. 511, was whether the taxpayer, engaged in the production and sale of sand, was entitled to a credit under Section 26 (c)(2) of the 1936 Revenue Act because of a contract requiring it to pay to a trustee, under a bond indenture, 25 cents per ton for sand

sold, for the bond-sinking fund. The Board held that the requirement of 25 cents for each ton of sand produced and sold was one expressly dealing with the disposition of earnings and profits of the taxable year because this sinking fund provision in dealing with the taxpayer's gross receipts necessarily included the disposition of "earnings and profits."

The taxpayer made a payment in January 1937 for the sand produced and sold in December 1936. In allowing this payment as a credit in the determination of the 1936 tax the Board said at page 515:

> "Since it would be impossible to compute any monthly payment due the sinking fund here until after the close of the month, the contested credit shall include the payment for sand sold during December of the taxable year, 1936, even though that payment was not physically made until January 1937. This seems proper on the theory that such payment was made *as of* December, 1936."

The Board of Tax Appeals based its decision in the case at bar (*Strong Manufacturing Co. v. Commissioner*, 41 B. T. A. 1273, Taxpayer's Brief, Appendix B), on the above decision in *Michigan Silica Co. v. Commissioner*, 41 B. T. A. 511, stating:

> "On this record, compliance with these conditions is questionable only in one respect. There was a written contract executed prior to May 1, 1936, containing a provision expressly dealing with the disposition of earnings and profits for the taxable year. The credit claimed is for an amount equal to the portion of such earnings and profits required to be paid in discharge of a debt, and this amount was paid in the taxable year. The sole remaining condition is that such portion of the earnings and profits be required by the contract to be paid or irrevocably set aside within the taxable year. We are of the opinion that the 'application' to the indebtedness of the designated portion of the earnings may, for present purposes, be considered to be called for by the contract 'as of' the taxable year, *Michigan*

Silica Co., 41 B. T. A. 511, 515, and, therefore, to constitute the irrevocable setting aside contemplated by the statute. The credit should have been allowed and respondent's determination to the contrary is overruled."

The practical and utter logic in the majority decision of the Board of Tax Appeals in the instant case seems irrefutable.

The minority opinion, on the contrary, simply adopts the narrow, technical view of the Commissioner's Brief in this case and holds that, because Taxpayer's note and mortgage, *in haec verba*, neither requires a payment or an irrevocable setting aside of profits during the taxable year of 1936 for the payment thereof, Taxpayer is entitled to no relief. Taxpayer submits that until the Commissioner and the minority opinion of the Board of Tax Appeals explain how Taxpayer could otherwise dispose of 40% of its 1936 profits, as they *accrued* than to set aside such profits for payment on its said indebtedness, without defaulting on its contract—which neither attempt to do—the position of the Commissioner and of the minority opinion of the Board in this case should find no acceptance with this Court.

The Board of Tax Appeals has alike given a reasonable and common-sense application of 26 (c)(1) of the 1936 Internal Revenue Act. *Prudential Fin. Corp. v. Commissioner* (1942), 46 B. T. A. 796; *Carolina-Florida Realty Co. v. Commissioner* (1942), 46 B. T. A. 777; *Paraport Theatre Leasing Corp. v. Commissioner* (April 8, 1941), 44 B. T. A. No. 14; *Kibly Steel Co. v. Commissioner* (May 24, 1940), 41 B. T. A. 1237; *Sutcliff Company v. Commissioner* (May 1, 1940), 41 B. T. A. 1009.

10. THE DECISIONS OF MOLONEY ELECTRIC CO v. COMMISSIONER (1941), 120 F. (2d) 617, AND ANTIETAM HOTEL CORP. v. COMMISSIONER (1941), 123 F. (2d) 274, RELIED ON BY THE COMMISSIONER, DISTINGUISHED FROM TAXPAYER'S CASE ON THE FACTS.

The case of *Moloney Electric Co. v. Commissioner* (1941), 120 F. (2d) 617 (C. C. A. 8th), is distinguished, on the facts, from the case at bar, in the following respects:

(1) The Trust Agreement relied on in that case did not require the setting aside of the required percentage of the earnings in the sinking fund for the retirement of bonds until the total annual profits for 1936 had been determined. Such determination was not required to be made before April 1, 1937. Actual payment of the profits to the Trustee were not required to be made until June 1, 1937. In the case at bar, Taxpayer was required to "apply" or, as has been shown, irrevocably set aside 40% of its 1936 profits as they accrued for the payment of its note and mortgage debt.

(2) While the taxpayer in the *Moloney* case had actually paid over $690,000 in retirement of all said bonds in 1936, there was no evidence in the record in that case to show what part of such amount was from the taxpayer's 1936 earnings or that any amount had been paid under the provisions of the indenture requiring the payment of 1936 profits on its bonded indebtedness or what the net earnings were at the times 1936 payments were made. In fact, the bonds redeemed in 1936 were taken up pursuant to an option in a totally unrelated article of the indenture. In the instant case, the evidence is undisputed that Taxpayer, The Strong Manufacturing Company, made its 1936 payments wholly out of 40% of its 1936 profits and in that year.*

In the case of *Antietam Hotel Corp. v. Commissioner* (1941) 123 F. (2d) 274 (C. C. A. 4th) there was no setting

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* Certiorari was denied in the *Moloney* case by this Court, November 10, 1941 and a rehearing denied January 12, 1942.

aside of the profits applicable to the taxpayer's indebtedness in the taxable year. In the Strong case, here at bar, the money was not only set aside—it was paid over to Taxpayer's creditor,—certainly an act of segregation of the most final nature. By way of *obiter dictum*, clearly unnecessary to the decision of the case, the court, in the *Antietam* case, held that the contract there involved did not, in terms, require the irrevocable setting aside of any portion of its profits and so the taxpayer, for this additional reason, was not entitled to the credit claimed. Section 26 (c)(2) does not require such provision of a contract to be explicit as a basis for claim thereunder. This holding was clearly unnecessary to decide the case on the facts there present and, in no event, binding as a precedent.

Taxpayer is convinced this Court will find nothing in the above decisions to impair the validity of the decisions of the court below or the Board of Tax Appeals or Taxpayer's contentions here made.

VIII. CONCLUSION.

Taxpayer believes the decisions of the United States Circuit Court of Appeals and of the Board of Tax Appeals were correct for the reasons that:

1. A clear intent was shown by the Reports of Hearings Before the Committees of Congress considering the 1936 Revenue Act, and by discussions in the sessions of Congress before its enactment, to tax only corporate profits earned in 1936 which were retained by the corporation, and to affirmatively grant a credit as to obligatory distributions of profits pursuant to a contract such as Taxpayer's.

2. The general title of the Revenue Act of 1936, declaring a purpose to equalize taxation, and the sub-title of Sections 13 (a) and 14 of said Act, imposing a tax on *undistributed* profits of corporations and of Sections 26 (c) and 26 (c)(2), granting a credit in respect to contracts re-

quiring the setting aside or payment of dividends on obligations created a presumption that Taxpayer's contract, which required the irrevocable setting aside of Taxpayer's 1936 profits to the extent needed to discharge its indebtedness, and the performance thereof, entitled Taxpayer to a credit under the facts in this case.

3. Taxpayer's contract complies with Section 26 (c)(2) of the 1936 Revenue Act in the respect that the controlling language of the provisions in issue contain words synonymous to the pertinent words therein contained.

4. Section 26 (c)(2) was intended to cover a class of contracts executed and delivered prior to its enactment and not formulated with the purpose of enjoying its benefits and,—generally,—to exempt all distributions of corporate profits, especially if paid under the express provisions of a contract to discharge a debt, and, therefore, Taxpayer's contract is in accord with every requirement of Section 26 (c)(2) construed according to such legislative intent and its performance entitles Taxpayer to the credit claimed.

5. The presumption raised by the facts in this case that Section 26 (c)(2) qualifies Taxpayer to a credit based on its setting aside and paying $46,500.00 of its 1936 profits in the taxable year 1936 to discharge its note and mortgage is aided by controlling rules of statutory interpretation and decisions requiring that the transaction in question be viewed in the light of common sense, standard business practice, and not according to a technical or strict construction, as contended by the Commissioner, and, finally that all doubts should be resolved in favor of Taxpayer.

Taxpayer, therefore, prays that the decisions of the Court and Board of Tax Appeals below should be affirmed, allowing a credit on its 1936 corporate undistributed profits surtax, based on the irrevocable setting aside and payment,

out of its 1936 profits and earnings, of $46,500.00 in discharge of its note and mortgage to The Central National Bank of Cleveland, in accordance with the specific provision of said note and mortgage and Section 26 (c)(2) of the 1936 Revenue Act, and that the deficiency assessment of the Commissioner levied in respect of said portion of Taxpayer's 1936 earnings and profits, be finally set aside and held for naught.

Respectfully submitted,

ARTHUR MORGAN,

RAYMOND S. POWERS,

Attorneys for The Strong Manufacturing Company, Respondent.

MORGAN, POWERS & COOPER,
704-5 Union National Bank Bldg.,
Youngstown, Ohio,
Of Counsel.

October 15, 1942.

APPENDIX A.

Opinion of the United States Circuit Court of Appeals for the Sixth Circuit.

(124 F. (2d) 397.)

Decided December 9, 1941.

Before HAMILTON, MARTIN and MCALLISTER, Circuit Judges.

MCALLISTER, Circuit Judge. The Commissioner of Internal Revenue filed his petition for review of the decision of the Board of Tax Appeals that The Strong Manufacturing Company was entitled to a credit on its 1936 surtax on undistributed profits by virtue of Section 26 (c)(2) of the 1936 Revenue Act.

The above mentioned section of the act, in so far as here applicable, provided that credits on undistributed profits shall be allowed to a corporation to the extent that earnings and profits are required to be irrevocably set aside within the taxable year for the discharge of a debt, provided they are so required to be set aside by written contract executed by the corporation prior to May 1, 1936. The taxpayer, an Ohio corporation, purchased its plant and equipment from the Central United National Bank of Cleveland about April 15, 1932, for the sum of $50,000. The purchase price was evidenced by a note, secured by a mortgage executed by the taxpayer to the bank, providing for payment in eight installments of varying amounts, due on April 15, 1934, and on the same date of each year thereafter. Stipulations in the note set forth that the corporation could anticipate unpaid installments in whole or in part; and it was further provided in the note:

> "In addition The Strong Manufacturing Company shall apply forty per cent (40%) of its net earnings in and for any calendar year beginning January 1, 1934, upon the unpaid balance of said purchase price, provided that the amount so applied shall never be less

than the installment of the purchase price specified for payment in such year, all as more fully set forth in said mortgage deed."

The mortgage set forth:

"The Company covenants and agrees that until the principal and interest of the note hereby secured shall have been fully paid beginning on January 1st, One Thousand nine hundred thirty four, the Company shall apply forty per centum (40%) per annum of its net earnings for any calendar year in payment of the interest accruing and becoming payable upon such note in such year, and the balance of the principal amount of such note unpaid prior to April 15th in such year; provided, however, that the covenant herein made shall not be construed to relieve the Company from the payment on April 15th in such year of the installment specified for payment by the terms of said note nor of the regular interest payments in such year, likewise as specified in said note."

It was further provided that if the corporation defaulted, and such default continued for thirty days, the bank could declare the entire balance immediately due and payable; and no waiver of any default by the bank should affect any subsequent default.

In 1934, the taxpayer obtained from the bank a written extension on a then due installment of $2,000, principal, and $3,500, interest, on the note and mortgage. The extension was on the specific condition that it should not be considered a waiver of any subsequent defaults; and the bank did not waive or make any concession in respect to the covenants of the note and mortgage requiring the taxpayer to apply 40% of its net earnings in payment of the debt.

During 1936, the taxpayer made payments out of profits on the principal of the note, in various months, aggregating $46,500, whereupon the bank waived payment of a small amount of principal and some interest, and accepted such payments in full for the balance due on the note and mortgage. The taxpayer claimed that these aggregate pay-

ments on the note and mortgage, which it made in 1936, are entitled to credit on undistributed profits and that by virtue of the provisions of the act, it is not taxable thereupon.

The relevant provisions of the statute read:

> "In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—
>
> (c) Contracts Restricting Payment of Dividends.
>
> (2) Disposition of Profits of Taxable Years.—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word 'debt' does not include a debt incurred after April 30, 1936."

Petitioner insists that the contract did not require that respondent irrevocably set aside a portion of its earnings of the taxable year within that year for the discharge of the debt; and that inasmuch as the contract did not come within the required terms of the statute, respondent is entitled to no credit for the payments made.

The question, therefore, before us for determination, is whether the payments made by the corporation upon its debt are taxable as undistributed profits, or whether it is entitled to credit on the basis of earnings and profits "irrevocably set aside within the taxable year for the discharge of a debt."

In brief, the statute allows a deduction on the tax in question where a contract requires a corporation to set aside irrevocably a portion of its profits within the taxable year for the payment of a debt. In this case, the contract of the corporation requires it to apply 40% of its net earnings for any calendar year to pay the balance of the debt, or a portion thereof, in that year. It is contended on behalf of the Commissioner that, because settlement on the debt could be made in the succeeding year, the contract does not require the irrevocable setting aside of such profits in the year in which they are earned. On the other hand, respondent corporation contends that, inasmuch as it is bound to "apply" its profits for the calendar year to the payment of the balance of the debt remaining unpaid in that year, this obligation comes within the requirement of the statute and constitutes a contract to set aside irrevocably a portion of its profits to the payment of a debt within a taxable year.

The phrase "set aside" has various meanings and connotations. One is "reserve"; and "reserve" is defined as "to keep back," "to retain," "to keep in store for future or special use," and "to retain or hold over to a future time"; "irrevocable" is defined as "incapable of being recalled or revoked." *Webster's New International Dictionary.* To sustain the respondent, we are required, however, to construe the statute to the effect that "to set aside" means: to place in a separate fund; to carry under a separate entry or in a separate account; to transfer to a trustee; or some equivalent act of physical separation or appropriation of the profits, for the payment of the debt. If the statute provided that the corporation would be entitled to credit by virtue of a provision of a contract requiring it to keep, retain, or reserve, without right of revocation, a portion of its profits within the taxable year for the discharge of a debt, it would seem that respondent would be entitled to credit on the tax. Whether such a con-

struction can properly be given the statute, and whether the conclusion reasonably follows that respondent is entitled to credit, depends upon accepted rules of statutory construction.

The construction of the statute for which the Commissioner contends would forbid credits to any corporation whose business was such that it could not definitely ascertain its profits on the last day of the year; and this would exclude from such benefits all corporations that were obliged to take an inventory that could not be completed within the year. Obviously, the result would be to deny such credits to practically all manufacturing and merchandising corporations, and to admit only those financial companies whose earnings and profits are generally susceptible of immediate computation. This would be unjust. Payment of the high surtax would work an unusual hardship on a corporation that was required, under penalty of mortgage foreclosure, to pay such earnings on its mortgage debts. Furthermore, the result of sustaining the claim of the Commissioner would be to require payment of a surtax on undistributed profits where there were no undistributed profits, by reason of the fact that the earnings, under inexorable conditions of a contract, were required to be paid upon a debt. This would be unjust and result in a burden of an especial and unusual nature.

Where a particular construction of a statute will produce inequality and injustice, that view is to be avoided if another and more reasonable interpretation is present in the statute. *Constantine v. United States*, 75 Fed. (2d) 928, Aff., 296 U. S. 287. The strict letter must yield to the evident spirit and purpose when necessary to give effect to the intent of Congress; *Fleischmann Const. Co. v. United States, to use of Forsberg*, 270 U. S. 349; for a thing which is within the intention of the statutes is as much within the statute as if it were within the letter, and a thing which is within the letter of the statute is not within the statute,

unless it is within the intention of the maker; *Northwestern Mutual Life Insurance Co. v. Gridley*, 100 U. S. 614; and where the meaning is uncertain, a statute will be construed so as to avoid unnecessary hardship. *Burnet v. Guggenheim*, 288 U. S. 280. The duty of the court, being satisfied with the intention of the legislature, is to give effect thereto and not to defeat it by adhering too rigidly to the mere letter of the statute or to technical rules of construction. *Oates v. First National Bank*, 100 U. S. 239.

In the application of taxing statutes, substance and not form should control; *Sanborn v. Commissioner of Internal Revenue*, 88 Fed. (2d) 134, cer. den., 301 U. S. 700; and such laws should be construed and applied with a view of avoiding, as far as possible, unjust consequences. *Farmers Loan and Trust Co. v. State of Minnesota*, 280 U. S. 204.

In ascertaining the purpose of the legislature in enacting a statute, the court may examine its title and the legislative scheme or plan by which the object of the act is to be carried out; *United States v. Katz*, 271 U. S. 354; and the intention is to be ascertained, not by taking a word or clause from its setting and viewing it apart, but by considering it in connection with the context, general purpose of the statute, occasion and circumstances of its use, and other appropriate tests for the ascertainment of the legislative will. *Helvering v. Stockholms Enskilda Bank*, 293 U. S. 84. The purpose of all statutory construction is to give effect to the legislature's intention and, hence, no rule of strict construction, which will defeat a statute's purpose, can be applied to its bare language.

The general title of the 1936 Revenue Act sets forth its purpose to "provide revenue, equalize taxation, and for other purposes." The subtitle of Section 26 (c) of the act reads: "Contracts restricting payment of dividends," and the title of Sub-section 26 (c)(2) is: "Disposition of profits of taxable year." In the message of the President to Congress with respect to the enactment of the statute,

the provisions of which are under consideration, he directed attention to a form of tax for the purpose of removing inequalities in the tax system, and mentioned, in this regard, the accumulation of surplus in corporations and the freedom of such undistributed corporate income from surtax. *Message of President to Congress,* March 3, 1936. In the report of the Ways and Means Committee of the House of Representatives on the Revenue Bill of 1936, after quoting the message, the Committee stated that the President had requested Congress to raise additional revenue by some form of undistributed profits tax, and that the Committee recognized that the greatest defect in the system of taxation at that time lay in the fact that surtaxes on individuals were avoided by impounding income in corporate surpluses. It was further recommended that corporations should not be permitted to withhold from the beneficial shareholders unneeded corporate income at the expense of the revenue of the United States and to the detriment of the shareholders, *H. R. Rept. No. 2475, 74th Congress, Sec. Sess.* From these proceedings, the legislative intention and the general purpose of the act, are obvious. It was sought to prevent corporations from accumulating tax free surplus arising out of their failure to distribute the earnings to shareholders, with the result that the Government could not tax such individuals. The headings in the statute, above referred to, indicate the intent to grant credit on surtax imposed on undistributed profits to the extent that such profits were not declared as dividends by reason of a contract requiring a different disposition of such profits.

It is necessary to keep in mind that taxation is an intensely practical matter and the substance of the thing done, and not the form it takes, must govern. *Commissioner of Internal Revenue v. Ashland Oil and R. Co.,* 99 Fed. (2d) 588 (C. C. A. 6); and that common sense interpretation is the safest rule to follow in the administration

of income tax laws. "Gross income and deductions flow from trade, commerce and dealings in property carried on in the ordinary business way and in the determination of taxes, men should measure both by ordinary, every-day business standards." *Rhodes v. Commissioner of Internal Revenue*, 100 Fed. (2d) 966, 969 (C. C. A. 6).

With reference to the object of the statute to equalize taxation, it cannot be said that the resulting inequality of taxation, as contended for on behalf of the Commissioner, is consonant with such expressed purpose. There appears to be no reason founded on principles of fair dealing, accounting methods, ordinary business practice, or common sense, that would justify the unreasonable, capricious, and discriminatory plan of taxation, here sought to be established as the statutory law; and, in this case, in the absence of a clearly expressed intention to the contrary, it must be held that Congress did not intend to work inequality, injustice, and hardship, nor was it intended that the statute would have this meaning and effect.

We are of the opinion that, in accordance with the legislative intent, the contract, requiring the corporation to "apply" 40% of its earnings for any calendar year to the payment of indebtedness in such year, is encompassed by the requirement of Section 26 (c)(2) of the Revenue Act of 1936; and such application is equivalent to setting aside, irrevocably, profits within the taxable year for the discharge of a debt, and entitles the taxpayer to credit.

That the profits, which were required to be applied to the indebtedness, could not be computed until after the taxable year, casts no doubt upon the conformity of the contract to the requirements of the statute. Where the law requires debts to be charged off within the taxable year, in order to receive deductions, the statutory language is construed to allow deductions for debts *physically* charged off in the first months of the succeeding year, in recognition of practical business necessities; and it is held that Con-

gress did not intend that there should be any essential departure from the usual course of business in making book entries in order to comply with tax laws. *Hamlen v. Welch*, 116 Fed. (2d) 413 (C. C. A. 1); *Kentucky Rock Asphalt Co. v. Helburn*, 20 Fed. Supp. 364, Aff., 108 Fed. (2d) 779 (C. C. A. 6). Like principles are applicable to the ascertainment of profits, and credit for applications thereof on indebtedness.

The claim is advanced that because the duty to make certain regular stipulated payments did not, by contract, depend on the existence of earnings, therefore, the taxpayer is not entitled to credit for such payments on the indebtedness. But the taxpayer is only seeking credit for that amount of profits which, in accordance with the contract, it claims it irrevocably set aside for payment of the debt. If the contract, with respect to the setting aside of such profits, conforms to the requirement of the statute, it is immaterial that the portion of profits so set aside for the indebtedness, exceeded the stipulated sum which was required to be paid, regardless of profits. That such required payment was included in the percentage of profits required to be set aside, has no bearing upon the right to credit.

We are mindful of the fact that since the argument in the instant case, in *Antietam Hotel Corp. v. Commissioner of Internal Revenue*, ... Fed. (2d) .... (C. C. A. 4) (decided November 10, 1941), it was held "that as an indispensable condition precedent to the allowance of the credit, the contract must in terms require that a part of the earnings and profits of the taxable year be * * * irrevocably set aside within the taxable year." We do not arrive at the same conclusion, for we do not find from the language of the statute that the contract must require the earnings to be irrevocably set aside, *in terms*. With regard to the case of *Helvering v. Moloney Electric Co.*, 120 Fed. (2d) 617 (C. C. A. 8), in which it was held that the taxpayer was

not entitled to credit under the section of the statute in question, it appears that there was no showing in that case what the earnings of the corporation were, when the payment on the indebtedness was made, or whether the payment was ever made because of any contract requirement; and these circumstances were of paramount significance in that adjudication. Confronted by entirely different facts, it would appear that further discussion, for the purpose of distinguishing the cited case, would be fruitless.

In accordance with the foregoing, the decision of the Board of Tax Appeals is affirmed.

APPENDIX B.

Findings of Fact and Opinion of the United States Board of Tax Appeals.

(41 B. T. A. 1273.)

Docket No. 95626. Promulgated May 29, 1940.

Contract requiring application of a portion of petitioner's earnings and profits for the taxable year against indebtedness incurred prior to 1936, *held*, to require irrevocable setting aside of such portion and to entitle petitioner to a credit for purposes of the undistributed profits tax to the extent that such payment was actually made in the taxable year. Revenue Act of 1936, sec. 26 (c) (2).

Arthur Morgan, Esq., Raymond S. Powers, Esq., and *Sidney J. Collins, C. P. A.*, for the petitioner.

DeWitt M. Evans, Esq., Paul A. Sebastian, Esq., and *Stanley B. Pierson, Esq.*, for the respondent.

This proceeding was brought for a redetermination of a deficiency in petitioner's income and excess profits taxes in the amounts of $14,776.89 and $548.37, respectively, for the year 1936.

The issues presented by the pleadings are: (1) Whether petitioner is entitled to a credit under the provisions of Section 26 (c) (2) of the Revenue Act of 1936 in computing the surtax on its undistributed profits; and (2) whether petitioner was entitled to certain deductions for expenditures for repairs and replacements.

FINDINGS OF FACT.

Petitioner, an Ohio corporation organized in 1932, has its principal offices at Sebring, Ohio, and is engaged in the manufacture of enamelware.

On or about April 15, 1932, petitioner purchased its plant and equipment from the Central United National Bank, Cleveland, Ohio, trustee for the bondholders of the Sebring Manufacturing Corporation. The purchase price was $50,000, for which petitioner on April 15, 1932, exe-

cuted a note secured by a mortgage to the Central United National Bank (hereinafter referred to as the bank).

The note was as follows:

For value received The Strong Manufacturing Company, a corporation of the State of Ohio, promises to pay to Central United National Bank, of Cleveland, Trustee, or order, Fifty Thousand Dollars ($50,000) in the following installments (all payments to be made at the principal office of said Central United National Bank in the City of Cleveland, Ohio):

$ 2,000	on April 15, 1934
3,000	on April 15, 1935
5,000	on April 15, 1936
6,000	on April 15, 1937
7,000	on April 15, 1938
8,000	on April 15, 1939
9,000	on April 15, 1940
10,000	on April 15, 1941

Any unpaid portion of the said principal sum shall bear interest from April 15, 1932 at the rate of six per centum (6%) per annum until paid; such interest shall be paid semi-annually at said office of Central United National Bank on the 15th day of October and April in each year.

This note is issued pursuant to, and payment of the principal thereof and of the interest thereon is secured by a certain first mortgage deed dated as of April 15, 1932, duly made, executed and delivered by The Strong Manufacturing Company to Central United National Bank of Cleveland, Trustee, to which mortgage deed reference is hereby made to the same effect as if herein set forth for a statement of the properties and rights mortgaged and pledged and the nature and extent of the rights of the holder hereof.

As provided in said mortgage deed installments of the principal sum hereof may be anticipated in whole or in part by The Strong Manufacturing Company. In addition The Strong Manufacturing Company shall apply forty per cent. (40%) of its net earnings in and for any calendar year beginning January 1, 1934 upon the unpaid balance of said purchase price, provided

that the amount so applied shall never be less than the installment of the purchase price specified for payment in such year, all as more fully set forth in said mortgage deed. All payments in excess of the installment required under the terms hereof in any year, whether voluntary or obligatory, shall be applied by the holder hereof against the latest maturing installments of the principal sum hereof.

On the same date petitioner executed the mortgage securing the note. Its pertinent provisions are as follows:

ARTICLE I.

Anticipation of Payments upon Note.

(1) The Company covenants and agrees that until the principal and interest of the note hereby secured shall have been fully paid and beginning on January 1st, One Thousand nine hundred thirty four, the Company will apply forty per centum (40%) per annum of its net earnings for any calendar year in payment of the interest accruing and becoming payable upon such note in such year, and the balance of the principal amount of such note unpaid prior to April 15th in such year; provided, however, that the covenant herein made shall not be construed to relieve the Company from the payment on April 15th in such year of the installment specified for payment by the terms of said note nor of the regular interest payments in such year, likewise as specified in said note. The term "net earnings" as herein used means the gross earnings from the business of the Company for such calendar year, less all current expenses of the business, all taxes payable in such year by the Company and fixed charges other than those created by the note hereby secured.

Settlement for all amounts becoming payable under this provision in excess of the principal and interest payments absolutely required in the calendar year as of which such net earnings are determined shall be made by the Company to the Bank not later than April 15th of the succeeding year.

(2) The Company covenants and agrees that so long as the principal and interest hereby secured re-

main unpaid, it will furnish to the Bank quarterly statements of the financial condition and operations of the Company, and in addition, shall on or before April 15th in each year furnish to the Bank a detailed balance sheet as of the close of the preceding calendar year, audited by public accountants acceptable to the Bank. The Company shall also furnish to the Bank, at any time that it may so demand in writing, such information as may, in the Bank's judgment, be necessary and proper to give it sufficient ground for the taking or not taking of any action required or permitted hereunder, and shall permit the Bank or its agents, upon like demand at any time, to examine its premises, property, records and books of account, and the Company shall and will do everything in its power to facilitate such examination.

(3) The Company may, at its option, at any time so long as it is not in default under any of the provisions hereof, anticipate any part of the principal amount secured hereby. Any sums paid by the Company in excess of the principal and interest payments fixed by the terms of the note hereby secured, whether made voluntarily under the provisions of this paragraph or under the provisions of paragraph (1) of this Article I, shall be applied by the Bank in payment of the latest maturing installments specified in said note.

* * * * *

ARTICLE IV.

Remedies on Default.

(1) If the Company shall make default in the payment of any interest or principal specified in the note hereby secured, and any such default shall have continued for thirty (30) days; or shall default in the performance of its covenants contained in Article I, Paragraph 1 hereof, and such default shall have continued for thirty (30) days; * * * the Bank may declare the entire principal then unpaid immediately due and payable, and the same and the interest accrued thereon shall thereupon become and be immediately due and payable, anything in said bonds or herein contained to the contrary notwithstanding. * * *

(2) No waiver by the Bank of any such default by the Company, whether such waiver be full or partial, shall extend to or be taken to affect any subsequent default or to impair the rights resulting therefrom.

* * * * * *

The provision of article I, paragraph 1, above quoted, with reference to petitioner's obligation to apply 40 percent of the earnings of each year on the note and mortgage, was required by the bank in order that in prosperous years petitioner would devote a portion of its profits to the payment of the mortgage, and the bank would be protected to this extent should the company later become involved in difficulties.

On May 28, 1934, petitioner and the bank executed an agreement wherein it was recited that the company was not able to pay the principal installment of $2,000 due April 15, 1934, and was in default in payment of the interest in the approximate amount of $3,500. By the agreement the bank granted an extension to April 15, 1941, for the payment of the principal installment and an extension to April 15, 1935, for $3,000 of the delinquent interest. The extension on the principal payment was "with the understanding, however, that such extension shall not be construed as a waiver of any subsequent defaults."

There was no modification of the provision requiring petitioner to apply 40 percent of its net earnings in payment of the principal and interest.

Petitioner's income and excess profits tax return for the year 1936 reported a net income of $126,786.04.

On January 1, 1936, petitioner owed $47,000 on its indebtedness on the note and mortgage. During the year 1936 it made payments on the principal sum on the dates and in the amounts as follows:

2/15/36	$2,500	6/29/36	$1,000	9/15/36	$ 500
4/15/36	2,500	7/14/36	500	10/15/36	34,000
5/15/36	500	7/31/36	1,000		
5/29/36	1,000	8/14/36	500	Total	46,500
6/15/36	500	8/31/36	2,000		

The bank accepted the $46,500 payment in 1936 in full satisfaction of the $47,000 due, and also forgave $117.50 interest.

By September 30, 1936, petitioner's approximate profits were $86,000, and it had orders on its books in that month of approximately $100,000. Since it appeared that petitioner's profits would be such that 40 percent thereof would be in excess of the amount required to discharge the mortgage in full, it was decided to make the payment at that time. It would not have been possible to determine on January 1, 1937, the profits of petitioner for 1936 with complete accuracy.

The parties have stipulated, and we accordingly find, that petitioner should be allowed deduction of $2,215.88 as expenses for repairs and replacements during the taxable year.

OPINION.

OPPER: The present issue calls for the application to the foregoing facts of the provisions of Section 26 (c) (2) of Revenue Act of 1936[1] entitling a corporation to a

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[1] SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * * *

(c) CONTRACTS RESTRICTING PAYMENT OF DIVIDENDS.—

* * * * * *

(2) DISPOSITION OF PROFITS OF TAXABLE YEAR.—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable

"credit" against the "undistributed profits tax" if it complies with certain requirements.

On this record, compliance with these conditions is questionable only in one respect. There was a written contract executed prior to May 1, 1936, containing a provision expressly dealing with the disposition of earnings and profits for the taxable year. The credit claimed is for an amount equal to the portion of such earnings and profits required to be paid in discharge of a debt, and this amount was paid in the taxable year. The sole remaining condition is that such portion of the earnings and profits be required by the contract to be paid or irrevocably set aside within the taxable year. We are of the opinion that the "application" to the indebtedness of the designated portion of the earnings may, for present purposes, be considered to be called for by the contract "as of" the taxable year, *Michigan Silica Co.*, 41 B. T. A. 511, 515, and, therefore, to constitute the irrevocable setting aside contemplated by the statute. The credit should have been allowed and respondent's determination to the contrary is overruled.

Repair and replacement expenses may be deducted as stipulated.

Reviewed by the Board.

Decision will be entered under Rule 50.

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year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

BLACK, dissenting: I can readily agree that from the standpoint of reason and logic there would seem just as good reason for Congress to grant a credit in determining surtax on undistributed profits to a corporation situated as was the petitioner in the instant case as there was to other corporations which had contracts of indebtedness which come more precisely within the terms of the statute (Sec. 26 (c) (2), 1936 Act). But it is the precise statute which we have to construe and I do not see how it can be so broadly construed as to admit a credit to petitioner under the facts as they have been found.

The statute in question, which has been set out in the majority opinion, seems to provide four things as conditions precedent to securing the credit. These are:

(1) There must exist a written contract executed by the corporation prior to May 1, 1936. Here there was a written contract executed prior to May 1, 1936, and so that condition is fulfilled.

(2) This contract must deal with the earnings and profits of the taxable year. The contract in question does deal with 40 per cent of the net earnings of petitioner for the taxable year, so that condition is met.

(3) The contract must *require* the payment or the irrevocable setting aside of the earnings in question *during* the taxable year for the discharge of the debt in question. In the instant case it is plain that the contract does not require that the 40 percent of the net earnings be paid on the indebtedness *during* the taxable year. On the contrary, petitioner was granted until April 15 of the following year in which to make payment. So it seems clear to me that, in so far as payment is concerned, the contract in question does not meet the terms of the statute. But the statute grants the credit if there is a requirement in the contract that the portion of earnings in question be "*irrevocably set aside*" during the taxable year for the dis-

charge of the debt. I see nothing in the contract which required the taxpayer to irrevocably set aside any of its earnings of 1936 prior to the granted time of payment which was April 15, 1937. So, in the view I take, one of the conditions precedent is not met. I can not take the view expressed in the majority opinion that when the statute says that the contract must *require* either payment or irrevocably setting aside of earnings *within* the taxable year it means "as of" the taxable year. I see no warrant for such construction.

(4) The credit granted, when all conditions have been fulfilled, is the amount which "has been so paid or set aside." In the instant case there has been a payment all right on the indebtedness to the full extent of the credit claimed, but, as I view it, in the absence of a requirement in the contract that these earnings be paid or irrevocably set aside in 1936, their actual payment in 1936 becomes immaterial.

Congress in the Revenue Act of 1938 wrote a provision which seems to be broad enough to permit a credit under the facts and circumstances of the instant case. See Sec. 27 (a) (4), Revenue Act of 1938. This section, however, has no retroactive application and, for reasons which I have already stated, I do not believe that the credit which petitioner claims can be granted under the terms of the 1936 Act. I think the Commissioner should be sustained and I, therefore, respectfully dissent from the majority opinion.

MELLOTT and KERN agree with this dissent.